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MONEY AND THE CITIZEN

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** For publication during 1950*

MONEY
AND
THE CITIZEN

BY
W. HEDLEY ROBINSON
LATE FELLOW OF THE INSTITUTE OF BANKERS,

*Social
Science
Studies*

DUCKWORTH
3 Henrietta Street London W.C. 2.

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TO MY FRIEND
A. T. J. DOUBLE

Printed in Great Britain by The Riverside Press, Edinburgh

PREFACE

It is a remarkable fact that although money is one of the universal things in our daily lives, few people have a clear idea as to what it really is, how it comes into existence and how, if at all, it departs from its orbit of usefulness.

The average person exhibits confusion of ideas in believing, vaguely as a rule, that wealth and money are synonymous terms. He has an impression, still more obscure, that money comes into being as a result of 'the people's savings'; that the national wealth increases down the ages by such saving and that, through this increase, more and more money somehow evolves.

Others will voice the notion that the banks, in some undefined manner, gather up this saved money and lend it out again to industry. The budding banker is still informed by his text-books that the banks canalise the savings of the nation, which they release as loans to industrialists and other borrowers and so fertilise the production of the country.

Actually the banks do no such thing. Instead, they manufacture 'bank credit,' which is the same thing as bank money, by a mere stroke of the pen. Not very many years ago a distinguished banker of great erudition and literary attainments denied that the banks did in fact create money, and even to-day many who should know better are still unable to believe this obvious and demonstrable truth.

It is therefore primarily the object of this book to enlighten the ordinary person upon this far from easy question; to demonstrate exactly how the phenomenon occurs; to explain the bounds within which the Bank of England works to control money volume, under statutory authority, under Governmental influence, and in the light of its own wisdom born of three centuries of

experience (each of these factors fallible but evolutionary in development); to make intelligible the essential function of the banks as the operative agents under this system of money creation, subject to the fiat of the Bank of England.

In treating this subject it will be necessary to discuss the interactions between money, price-levels, production, and employment, all of which are factors mutually dependent upon one another. Necessarily banking history and practice must claim a large share of the exposition if we are fully to comprehend the system.

It is the aim of this book to explain these matters as simply and untechnically as possible; it will not be assumed that the reader already possesses a knowledge of economics or banking.

W. H. R.

THREADNEEDLE STREET,
LONDON, E.C. 2,
May 1943.

PREFACE TO SECOND EDITION

THE publishers have approached me to bring my friend Hedley Robinson's book up to date for the post-War student. This I have done by rewriting the last two chapters of the first edition as a single new Chapter XVI, covering developments during and after the Second World War, and by making a very few necessary amendments in the earlier chapters.

R. E. W.

LONDON,
July 1949.

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A GLOSSARY OF TERMS

- Acceptance.* (a) The act of signing across a bill of exchange, denoting acceptance of the obligation to pay the money specified in due course; (b) often colloquially used to signify the accepted bill itself.
- Accommodation.* Loans, overdrafts, financial assistance, or any other form of credit granted by a bank or other party, either with or without the deposit of collateral security by the person so accommodated.
- Accommodation Bills.* Bills of exchange which are not drawn in respect of a genuine trade transaction but are accepted without any value or consideration passing and solely in order to enable the drawer to obtain 'accommodation' from a banker or a moneylender. (See 'Kites'.)
- Account payee only.'* An annotation upon a cheque which constitutes a direction by the drawer to his bank that transfer by the payee is prohibited and that it should only be paid to the payee's banker. In practice it is left to the collecting banker to ensure that it is not handled for a party other than the payee.
- Annuities.* Sums of money paid annually to a person under an agreement, bond, or covenant. In the eighteenth century certain perpetual Government obligations were called Annuities because of the annual income they provided for their owners.
- Arbitrage.* Three (or more)-cornered transactions in foreign exchange whereby a dealer in one country may purchase the currency of a second country by selling in the latter his holding of the currency of a third. There may even be a chain of transactions through several currencies.
- Assets.* Cash, property, or securities and resources of all kinds owned by an individual or body of persons, as well as money owed to him, or them, by other parties.
- Assignment.* A transfer to another party of the rights in a deed or an instrument, or a transfer of property itself.

- Bank Money.* Purchasing power created by the banks, which is represented by the credit balances standing in the names of customers and by certain other accounts belonging to the banks themselves.
- Bank Notes.* Promissory Notes issued by Banks of Issue which, under a Gold Standard, are legally convertible into gold upon demand. When no Gold Standard is operative, and the notes are legal tender, they are inconvertible. Bank Notes are fully negotiable instruments.
- Bank Rate.* The minimum rate at which the Bank of England is prepared to discount approved bills for the money market.
- Bankers' Documentary Credit.* A letter issued by a bank undertaking to honour the bills of exchange drawn upon it by the beneficiary of the credit, up to a fixed amount, provided that certain specified shipping documents, such as bills of lading, invoices, and insurance policies for particularised goods, are attached to the bill. The Credit may be revocable or irrevocable. In the latter case the bank undertakes not to cancel it without the prior consent of the beneficiary. Such Credits are an essential factor in the conduct of international trade.
- Banking Department.* The Department of the Bank of England concerned with all activities other than the note issue.
- Bill of Exchange.* A written instrument, usually made out ('drawn') by a seller of goods who signs it and thereby requests the party drawn upon (usually the buyer or someone acting on his behalf) to pay on a fixed or future determinable date the sum specified therein, to, or to the order of, a designated payee or to the bearer. The drawee by signing his name across the bill signifies his acceptance of the terms thereof and becomes the acceptor. The payee, who may be the drawer himself, may, by endorsing the bill, assign his rights thereunder to any other person.
- Bill of Lading.* An instrument acknowledging that the goods specified therein have been received by the ship's captain for transport to the overseas port designated. Possession of the bill of

- lading is taken as the equivalent of ownership of the actual goods.
- Bills of Exchange Act.* The great Act of 1882 which codified all existing laws relative to bills of exchange and now regulates all transactions carried out by these instruments as well as by cheques and promissory notes.
- Book Debt.* Moneys owed by one party to another, the primary evidence of the obligation consisting of book-keeping entries.
- Bullion.* Gold or silver in bars, or coin in bulk.
- Bulls and Bears.* Originating on the Stock Exchange to signify respectively a man who has bought stock for a rise and one who has sold stock for a fall, the phrase has spread to speculators in any commodity, including foreign exchange. To be a little more precise as to the 'bear' position, this means that a man, believing that a fall in the value of a share or commodity is imminent, sells stock which he does not possess and arranges to defer settlement of the contract in the expectation that he will be able to buy in the stock at a cheaper rate than that at which he sold. If his hopes are realised, he utilises the cheap purchase to deliver against his dear sale and profits by the difference.
- Call and Short-Notice Money.* Money lent by the banks to the money market which is repayable either at call or upon notice being given (usually seven days).
- Capital : Authorised.* The maximum amount permitted to be raised by the subscriptions of shareholders under the terms of the Memorandum and Articles of Association (*i.e.* the statutes) of a Company.
- Capital : Paid up.* The proportion of the authorised capital which has been actually called up by the directors for the purposes of the company and paid for by the subscribers. The balance is the callable capital unless the statutes prohibit the directors from calling up a part of this, which part is then only available in case of a winding-up in circumstances where creditors do not receive 20s. in the £.
- Capital Goods.* Those which do not directly go into general consumption but are utilised to facilitate the output and distribution of consumption goods; examples are, factory buildings,

- machinery, dies, tools, railways, and transport materials, etc., etc.
- Central Banks.* Banks charged by the State with the duty of controlling the currency, the note issue, and the monetary economy of the country. Examples are, the Bank of England, the Banque de France, the Federal Reserve Bank, and the Reichsbank.
- Cheque.* A Bill of Exchange drawn upon a banker in favour of a specified payee, or the 'bearer,' and payable on demand. The signer of the cheque is the drawer and the bank the drawee. It is a direction by the drawer to the drawee to pay the funds designated therein to the payee or to 'bearer.'
- Clearing House (Bankers').* An institution for facilitating the presentation of cheques, and the settlements thereof as between the receiving and paying banks.
- Consumption Goods.* Those which pass directly into use to satisfy everyday human needs; examples are, food-stuffs, clothing, many manufactures, coal, electricity, etc. Many raw materials, such as jute, cotton, yarn, rubber, may be classed as consumption goods although they may only have reached an intermediate stage of completion.
- Contingency Accounts.* Accounts in which undivided profits are sometimes held for such purposes as dividend equalisation or provision for bad debts. Contingency accounts differ from Reserve Funds in that they are not usually disclosed as separate accounts in the balance sheet.
- Creation of Money.* A term used to designate the process of producing purchasing power as represented by bank notes and bank balances. This production is inherent in the functions of the Bank of England and the other banks and is effected by their acts in printing and issuing notes, in making loans to the Government and the public, and in purchasing gold and securities. (See 'Bank Money.')
- Credit.* This may, according to the context, be (a) a book-keeping entry showing an amount in favour of the person in whose name the account stands, (b) a banker's letter of credit (*q.v.*), (c) accommodation by loan or overdraft or by way of a book debt.

- Crossing.* Two parallel transverse lines drawn across a cheque with or without the addition of the words ' & Co.' The crossing constitutes an instruction to the bank upon which it is drawn not to pay the cheque over the counter or otherwise than through another bank, the latter being the agent for collection of the holder.
- Current Accounts.* Those upon which a customer may draw cheques without notice to the bank. In London no interest is allowed on such accounts although in some parts of the provinces it is allowed at very small rates. (Compare 'Deposit Accounts'.)
- Debentures.* Obligations issued by companies to secure debts. Usually they contain a first charge upon the total assets of the company, in which case they are known as Mortgage Debentures, and in a winding-up they entitle the holder to satisfaction from the proceeds of the assets mortgaged, in priority to creditors or shareholders.
- Deflation.* The act by the Central Bank or State authority of imposing a decrease in the volume of money which has the result of reducing prices.
- Demonetisation.* The act of reducing the status of a metal from that of a monetary standard to mere bullion. Thus, for example, Germany, which had a monetary system based upon the silver thaler, decided in 1871 to adopt the Gold Standard. The thalers therefore were called in, melted down, and sold as silver bullion. Thereafter the gold mark superseded the silver thaler as the monetary standard.
- Deposit Accounts.* Those upon which the owner surrenders his right to immediate repayment for an agreed period in order to gain interest. He has no right to issue cheques thereon.
- Deposit Banking.* Banking in which funds are received for the credit of the customer, against which he draws cheques for payments to his creditors and in respect of his cash withdrawals. The term is used to distinguish it from note-issue banking.
- Deposits—Other.* Balances on the books of the Bank of England standing to the credit (a) of the banks, (b) of other non-Government customers.

- Deposits—Public.* Balances on the books of the Bank of England standing to the credit of Government departments.
- Deposit Receipt.* A receipt given by a banker in respect of specific deposits of money, which sets out the agreed terms of interest and of notice of withdrawal.
- Discount.* The interest charged by a banker when he purchases or 'discounts' a bill of exchange. It differs from ordinary interest in that it is charged at the time the bill is discounted and not at maturity. Sometimes colloquially used to denote the bill itself.
- Discount Houses.* Financial institutions which specialise in the purchasing of bills of exchange.
- Drawee.* See 'Bill of Exchange.'
- Drawer.* See 'Bill of Exchange.'
- Drawn Bonds.* Where certain Government stocks and industrial debentures are repayable by degrees according to a definite scheme, the bonds selected for repayment are often determined by 'drawings,' or by lot. The numbers of the drawn bonds are published and it is necessary for the holders thereof to present them to the issuing State or company in order to receive the funds.
- Endorsement.* The signature on the back of a bill of exchange, cheque, or other instrument which operates as an authority to transfer it. The endorser by signing acknowledges his liability in respect of the instrument until it has been discharged by payment.
- Entrepreneur.* A word in economics indicating a man of enterprise; a capitalist who risks his capital in the manufacture of goods with the expectation of earning profits, which operations he personally directs.
- Equity Share.* That class of share which receives the residual profits of a business after all prior issues such as debenture or preference shares have been satisfied. The 'ordinary' shareholders usually possess the equity of a business unless there exist 'deferred' or 'founders' shares.
- Exchange Equalisation Account* An organisation instituted in this country with the double object (a) of defeating anti-national speculative activities in the foreign exchange markets and (b) of preventing

adverse influences upon our internal credit structure caused by movements of foreign capital funds, which movements otherwise may have disturbing effects upon the price-level.

- Exchange Rate.* The price at which a transaction in foreign exchange may be effected. In Great Britain the rates in the great majority of cases are quoted in terms of the amount of foreign money exchangeable for £1, but in a few the quotation is in terms of shillings and pence per foreign unit.
- Fiduciary Issue.* That part of the British note issue which is not covered, pound for pound, by gold. Instead, it is covered by British Government securities.
- Foreign Exchange.* Transactions wherein the rights to foreign currencies are bought and sold. These rights may be designated by notes, coins, cheques, bills of exchange, or any other instrument of transfer, in the money of the foreign country involved. Deals may be in respect of an immediate (spot) transfer of the currency or of one at a future date (forward contract).
- Gold Par of Exchange.* The equivalent of the unit of currency of one country in terms of the unit of another, under Gold Standard conditions. The equivalent is ascertained by comparison of the statutory gold contents of the two units. Thus, before 1914, £1 contained 113 grains of pure gold, whilst \$1 U.S.A. contained 23.22 grains. The par of exchange therefore was $£1 = \$4.86\frac{2}{3}$.
- Gold Points.* The dearest rate of exchange under a Gold Standard which can be reached before it becomes cheaper for a merchant to procure gold from his Central Bank and ship it to another country, paying freight, insurance and loss of interest (Outward Gold Point). Conversely the rate at which it similarly becomes cheaper for the merchant in the other country to withdraw gold and ship it to the first country (Inward Gold Point of the latter). For example, before 1914 our outward gold point in relation to the U.S.A. was about 4.83, whilst our inward gold point was 4.89.

- Gold Standard.* The state of having money tied to gold at a fixed rate. The bond between gold and money is cemented by a statutory obligation that, upon demand, gold shall always be exchangeable for money and money for gold at the fixed rate.
- Guarantee.* An undertaking given by a third party by which he holds himself responsible for the due fulfilment of an engagement made by the person guaranteed. The guarantee is usually in respect of the future repayment of a specific sum in money.
- Guinea.* A British gold coin obsolete since 1816. Nowadays a term for the sum of £1, 1s.
- Inconvertibility.* The state of having a note issue in respect of which there is no legal obligation to redeem the notes in gold.
- Index Numbers.* A statistical method of observing the movements of price-levels. It is effected by selecting a representative group of commodities and working out the cost at current prices. The figure at the standard period is then reduced to 100 and subsequent calculations are expressed as a percentage of this figure. (See also 'Weighting'.)
- Inflation.* The act by the Central Bank or State authority of permitting an increase in the volume of money which has the result of increasing prices.
- Interest.* The payment made by a borrower for the use of the money, whether such borrower is a customer or a bank. The rate of interest in banking is usually more or less closely related to the 'Bank Rate.'
- Issue Banking.* An expression of the old eighteenth-century view that the principal business of a banker was the issue of notes. The antithesis of this is the term 'Deposit Banking.'
- Issue Department.* The Department of the Bank of England concerned with the note issue. It was segregated from the banking business by the Bank Act of 1844.
- Joint Stock Bank.* One which is registered under the Companies Acts and the capital of which is held by a number of shareholders.
- Kite.* An accommodation bill (*q.v.*).
- Legal Tender.* The attribute conferred by Government upon any particular form of money which makes

- it compulsorily acceptable when tendered by a debtor to his creditor.
- Letter of Credit.* A document issued by a bank which expressly authorises the holder to draw cheques upon it up to a specified amount. Since the bank thereby guarantees payment of such cheques, the letter of credit provides a very convenient way of obtaining cash when travelling abroad or at home, for other banks will readily exchange the cheques for cash.
- Liabilities.* Money owed to or obligations outstanding toward other parties.
- Limited Liability.* A company is said to be formed with limited liability when the liability of the proprietors is limited to their investment in the shares of the company, their assets outside the business not being available in the event of default by the company. A shareholder is therefore only liable for further payments to the extent of the 'uncalled' amount on each share held by him.
- Liquidity.* The property of being easily sold or otherwise readily converted into cash.
- Loan.* Accommodation to the extent of a definite fixed sum, which amount is debited to the customer's loan account and credited to his current account, whence it is disbursed by cheques at will. A loan has the initial effect of creating an addition to the volume of money.
- Management of Money.* The process of regulating the quantity of bank money in existence, with the object of controlling the value of money in terms of commodities.
- Merchant-Banker.* An individual who, or a firm which, at one time carried on foreign trading but has since discarded such activities in favour of the specialised handling of foreign banking business.
- Money Market.* In the general sense it comprises the whole British financial system of banks and others. Usually however the term is confined to the group of London Discount Houses and bill-broking establishments.
- Negotiability.* The property conferred by custom or by statute upon certain instruments whereby they convey a good and full title to a holder who takes them *bona fide* and for value

- even though there may be a defect in the title of a previous holder.
- Old Lady of Threadneedle Street.* A cognomen applied to the Bank of England. It may have originated from the figure of Britannia on the notes, from a speech by Sheridan in the House of Commons in 1797 in which he compared the Bank to an elderly lady who had fallen into bad company, or from a cartoon published in 1798 or so which depicted Pitt attempting to obtain the Bank's gold from an elderly lady seated on a locked box.
- Open Market Policy.* The practice pursued by the Bank of England of purchasing securities on the open Stock Exchange whenever it is considered necessary to increase the volume of national bank money, and conversely of selling securities to reduce the volume of money.
- Overdraft.* A facility whereby the customer is permitted to draw cheques on his current account even though no funds are present to meet the cheques. He may continue to draw until an agreed maximum debit balance is reached. An overdraft has the initial effect of creating an addition to the volume of money in the same manner as does a loan.
- Over-issue.* A condition occurring when notes under Gold Standard conditions are issued with an insufficiency of gold backing, or when inconvertible notes are issued in excess of the real needs of the population.
- Price Indices.* See 'Index Numbers.'
- Price-Level.* See 'Index Numbers.'
- Private Bank.* One which is owned by one or more partners up to the maximum number of ten. The liability of such partners is unlimited for all the commitments of the bank.
- Proportion (The).* Formerly the relation between the gold held by the Bank of England and the notes issued by it, but since 1844 the relation between the notes held in the Banking Department and the total of 'public' and 'other' deposits upon its books.
- Quantity Theory of Money.* The theory which states that prices vary directly with the quantity of money available for purchases and inversely with the volume of goods available for sale. This

- statement of the theory however is crude, and must be considered in conjunction with the velocity of circulation. (See Chapter VII.)
- Reserve Fund.* That part of the undivided profits of a company which is specifically allocated to meet emergencies or losses that may arise in the future. (See 'Contingency Account.')
- Rest.* A term used by the Bank of England to denote the account wherein lies its reserve fund and undivided profits.
- Savings Bank Accounts.* Those in which deposited funds are withdrawable only under strictly defined conditions. They are intended to receive small savings cumulatively added and they earn interest. Cheques may not be drawn against these accounts.
- Securities : Other.* Advances made to, and bills discounted for, non-Governmental customers by the Bank of England.
- Securities : Public.* Advances made by the Bank of England to the Government (Ways and Means) and its holdings of Government Securities.
- Standstill Agreement.* The arrangement made between the London and other international bankers on the one hand and Germany on the other in connection with the default of the latter in 1931 in respect of the repayment of her short-term indebtedness.
- Stock Exchange Securities.* Stocks and shares which are dealt in upon the Stock Exchange. They may be (a) registered, that is, entered upon the lists of shareholders which are kept by the companies; evidence of ownership is provided by the stock or share certificate issued by the companies in the name of the shareholder. Change of ownership must be effected by both parties signing a transfer deed and surrender of the certificate to the company to enable it to issue a fresh one in the name of the new shareholder;
- (b) in bearer form; possession of the bond representing the holding is evidence of ownership. Bearer bonds are negotiable instruments. They are generally, though not invariably, in respect of fixed-interest Government stocks and industrial debentures; the interest or dividend payments

are usually payable upon presentation of the coupons attached to the bond.

- (c) Some stocks are inscribed ; that is, they are transferable by inscription upon the books of the banking agent of the issue concerned. Actual attendance at the office of the agent is necessary, either personally or by an attorney, in order to make transfers of stock.
- (d) Some share certificates when endorsed become virtually bearer instruments. Dividends, therefore, have to be collected from the party in whose name they are registered. This type consists mainly of American shares.

Trade Clearings. These are politico-financial arrangements made between pairs of countries, which aim at ensuring that imports and exports between the two are evenly balanced.

Travellers' Cheques. These are printed cheques issued by a bank for definite amounts, usually £5 and £10. As they provide for identification of the holder, and are a direct obligation of the issuing bank, they offer a convenient method of obtaining funds when travelling abroad or at home.

Treasury Bills. As the name implies, they are instruments issued by the Treasury in respect of money borrowed by the Government and are similar to bills of exchange. They are issued to applicants, usually under tender, at rates of discount varying with current circumstances. They constitute a part of the nation's unfunded debt.

Velocity. A term used in discussing the 'quantity theory of money' to denote the varying speeds at which money changes hands in the process of spending.

Ways and Means Advances. Temporary loans made by the Bank of England to the Government.

Weighting. A term applied in economics to the process of accentuating the quantitative importance of certain commodity components of a price-index calculation. It arises from the recognition that one commodity may have a greater usefulness than another in the scale of human needs and thus requires relatively greater weight to be given to its claims when the list is being compiled.

Chapter I

THE GENESIS OF MONEY

DOWN the long vista of centuries mankind has continually been exercised in mind on questions of money. It has ever been recognised, though gropingly, vaguely, and intermittently, that in a world of competitive private ownership the proper regulation of money is the primary factor governing prices, and through prices, employment, wages, profits, and industrial growth. The principles which ought to govern that regulation are still problems far from solved, although we are perhaps now gradually approaching their solution. An endeavour to indicate some of the main considerations involved in the process will be found in the course of this and the succeeding chapters.

A knowledge of monetary history is desirable and, although limitations of space will necessarily curtail the attention that we may devote to this, some description, however slight, will aid that understanding of modern problems which is so essential to our purpose.

The origin of the word 'money' is obscure. The Latin word is *moneta*, and some believe that it is derived from the fact that money, in Roman times, was minted in the Temple of Juno Moneta. Others, however, think that the suffix was tacked on to the name of the goddess because of the *moneta* which was made in her Temple. If the latter view is correct, the name 'money' must have been of still earlier origin. In either case it is entirely academic and the word had its beginnings comparatively late in the history of our subject.

Primitive man tended to fall into small nomadic groups, bound either by family ties or by motives of self-interest and mutual protection. Each group raised, captured, or fashioned for itself all the modest requirements in food and clothing of its component

members. Property in the more enduring sense existed not at all and there would therefore be nothing exchangeable as between individuals or groups.

As the groups settled down in course of time, and the nomadic style of their existence gradually ceased, property increased and became of a more permanent nature. The dwelling-places, instead of being caves or mere crannies in the rocks, became fashioned of wattles, of wood, or from the skins of animals. Weapons were made from flints or wood, fish-hooks from bones. Again, instead of man being dependent for his food upon his cunning in killing wild beasts, domestic cattle were tamed and raised; these in turn required enclosures to be fashioned to protect them from the depredations of animals of prey or from rival tribal groups. In this manner, whether a fact to be deplored or otherwise, the system of personal or, at all events, tribal property gradually evolved.

Evolution of Barter

Once some form of law and order was established, and acquirement of another's goods by theft or force became less and less easy or profitable, it was but a short step to the institution of some form of 'swapping' or barter. Were one to covet something possessed by a neighbour, it would become natural to approach him and hint at one's desire in the most roundabout and least anxious manner possible; this with the idea of discreetly finding out what the neighbour lacked and how much of the lacking commodity, if indeed one had it, he would accept in exchange. How often would it occur that friend neighbour would indeed be willing to deal, only to find nothing sufficiently attractive offered as the counterpart. Or, to take a concrete example, one desiring a flint axe would find it necessary to take a load of them because the only possible subject for exchange proved to be an indivisible horse. True, some bright fellow might have taken the axes in the

hope that his wits would enable him to re-exchange them before long for more desirable things. Clearly barter was too cumbersome and uncertain as human progress developed.

Common Denominators of Exchange

Gradually it would emerge that, amongst the various communities, one particular article or commodity would be more generally prized than any other. It was then a natural step to begin to measure the exchange value of any other article in terms of the prized one. Thus at different periods and in various regions it came about that flint weapons or tools, salt, wheat, rice, skins or heads of cattle emerged as the common denominator of exchange. The persistence of the last-named is well shown by the fact that we have in our language to-day a word associated with wealth, namely, 'pecuniary'; alas! to most of us personally the derivative 'impecuniosity' is perhaps its best-known form. The word comes to us from *pecus*—a head of cattle, and demonstrably derives from the time when oxen were the acknowledged media of exchange.

In time, as intercourse grew between groups or families more and more widely separated by distances from each other, and even divided by the seas, it necessarily happened that a medium of exchange such as cattle was not a practicable proposition. But by now the arts of metallurgy had become more widely practised, and copper, tin, lead, iron, mercury, silver, and gold passed into common usage and were fashioned into articles of utility. These metals opened up such great possibilities of usefulness that it is not at all surprising that some of them became new common denominators of exchange. Their universal desirability, coupled with the ease with which they could be divided into smaller or larger units of quantity, would naturally be a very strong factor in establishing their several positions at various times and places as the supreme

article of common exchange. Another virtue existed, in that the quality of each metal would be found fairly constant throughout; no vexatious questions of variations would occur such as in the case, for example, of cattle, where the size, condition, age, or sex introduced additional complications into the haggling process.

Gold and Silver supplant other Media of Exchange

By degrees gold and silver ousted all the others in popular favour as the principal measures and standards of value. This was attributable to their relative scarcity, which gave them a high value, weight for weight, as compared with other metals or commodities, added to which was their attractive appearance. Another distinctive attribute was their freedom from liability to oxidation, a feature denied to most of the others. Then, in addition to the portability already mentioned, they possessed homogeneity, durability, malleability, stability of value (though of this latter much will have to be said in later chapters), to mention a few of the 'ities' commonly attributed to gold and silver. Finally the absence of that deterioration inherent in most non-metallic commodities completed the points in favour of the two so-called precious metals. The fascination which they have had upon the mind of mankind has lasted undiminished down the centuries and it is only during the last few decades that any serious revulsion from this sentiment has become manifest.

Silver and, to a lesser extent, gold became, then, the favourite media of exchange. We read of transactions carried through in this manner in the Bible, in Sanskrit or Egyptian papyri, in the early Greek writings. In every case, history tells us that such-and-such a weight of metal changed hands in consideration of the transfer of this property or the performance of that service; the idea of coinage had not yet been evolved, and transfers by count had not taken the place of

transfers by weight of the exchanging metal. With the object of facilitating subdivision it was a natural step, however, for the silver to be fashioned either in bar form of circular cross-section or in strips; the desired weight could then readily be detached by means of the chisel with a fair degree of accuracy.

The Evolution of Coinage

The inconvenience of weighing, not to mention possible distrust of the merchant's scales or weights, would logically lead to an attempt either to standardise the pieces struck off or to impress upon the lumps an indication of their weights. Merchants and others who were generally trusted might hammer their sign or trade mark on to the lump together with its mass in shekels, taels, libras, staters, or other local unit, and there would exist reasonable hope that the indication might be accepted as true. It naturally followed, as the demand grew, that the merchant had dies fashioned, bearing in reverse his mark or 'chop,' as it is still called in the East, and the weight of the potential coin; discs of silver would then be hammered into these dies and, thanks to the malleability of the metal, would readily take an impress. In this manner money, as it was understood for centuries thereafter, came into being.

It will be seen that a subtle difference had evolved. Earlier the precious metal had been accepted as much for its own intrinsic value as for exchange purposes; it was even perhaps already fashioned into articles of adornment. This advent of coined money gradually changed the metal token of value into a thing that was a more or less ephemeral possession. It was now merely a stepping-stone to a re-exchange back again into other goods at an earlier or later date. In other words, money had now reached its functional stage; it had become a measure of value not only for the immediate transaction but for others which would take place in the future; it had become a standard for deferred

payments. Prices of commodities came to be quoted in terms of the names of the units of gold or silver, such as Aurei, Libra, Drachmae, and so forth. The measure of wheat changed hands for an agreed number of drachmae, and the seller had confidence that when he wished later to make a purchase of hides he would have no difficulty in finding a merchant who would be agreeable to sell that commodity in exchange for drachmae also. It is possible, moreover, that the hide merchant would be ready to make an immediate contract for the sale of his hides at so many pieces per drachma, on the understanding, however, that delivery, alike of hides and drachmae, would not take place until an agreed future date. Thus we see what an immense stride had taken place in commerce through this growing confidence in the coined pieces of metal. The citizen was content to assume that the silver or gold remained of constant value; that it always retained the same degree of desirability for everyone; that any fluctuations in the terms of wheat, hides, cattle, and so forth could only, therefore, be due to variations in the available stocks or in the immediate demands for them on the part of would-be buyers. For centuries merchants were touchingly faithful to this convention or belief although, as we shall discover in later chapters, it has been sadly discredited by recent generations.

The Mercantilist Principle

This universal desirability of silver and gold gave rise during the Middle Ages to a principle which was known as the Mercantilist theory in relation to international or overseas trade. The theory in the sixteenth and seventeenth centuries actually guided the policies of the English Government in the laws enacted to control and foster the country's growing foreign 'adventures' (as overseas trade was then regarded). Mercantilism was the expression of a belief that trade was to be regarded as successful solely by the amount of bullion which it

brought into the country, a result which in more modern days is called a 'favourable' or an 'active' balance of trade. So firmly was this belief held that in the sixteenth-hundreds the export of gold and silver was actually prohibited by statute. The fostering of exports and the discouragement of imports were the natural results of adherence to this theory. Its ill effect upon national policies still persists to this day, with many disastrous consequences. The prohibition upon exports of gold and silver just mentioned had later to be rescinded, since the formation and growth of the East India Company in that period peremptorily necessitated free movements of bullion.

A pamphlet by one Thomas Mun, published at about this time, enunciated a policy of allowing freedom of bullion movements on the principle of 'set a sprat to catch a mackerel,' but he insisted that the whole business of trade still was to have that 'favourable' balance of payments so beloved of politicians even to-day. His work was translated into all civilised languages, and the pity of it was that it became the almost universally accepted principle. Although Adam Smith in his *Wealth of Nations* attacked the theory tooth and nail, and did actually influence public opinion to the extent that the theory was discredited for a century or more, the blight of Mercantilism, although in a modified and less crude form, has pervaded foreign trade policies the world over in this last two or three generations. With what unfortunate results we shall learn later.

Chapter II

THE EVOLUTION OF BANKING

BANKING as we know it to-day is a development quite modern in conception and certainly of not more than three or four centuries of experience. But the 'art or mystery' in a cruder and simpler form dates back very far into antiquity. The earliest records which have survived show that banking flourished as early as the seventh century before Christ, and it is possible that antiquarian research in the Near East may unearth relics from a yet earlier period.

The practice in those early days appears to have been confined to three main channels; these were, the safe custody of money, transfers of money from one centre to another, and the business of money-changing. Of professional lending there was but little; the age-old abhorrence of usury largely made impracticable any but personal loans free of interest, even where the laws did not definitely prohibit the 'sinful' charge. The Jews might not lend at interest to their fellow-Jews, though a Mosaic dispensation allowed them to charge the Gentiles, which permissive action probably resulted in the racial flair for finance which the Hebrews have always possessed. It was not until the late sixteenth century that the attitude of the churches veered round, first the Reformed and later the others, and the canon law ban on the practice was lifted. Then it was that the making of loans for reward could become a respectable calling.

Safe Custody of Money

Little need be said about the first-mentioned department of banking, for the safe-custody deposits were no more than a matter of keeping the actual metal under lock and key. An individual merchant, by honest

dealings, would so gain the confidence of his fellow-men that they would be encouraged to place their spare money, or silver or gold, into his keeping, he being responsible for its safety until such time as they required all or part of it back again, should opportunity arise of making a profitable purchase of goods or other forms of wealth. By relieving themselves of the trouble and risk of personally guarding their possessions the depositors acquired peace of mind and freedom of movement. This naturally was worth some monetary sacrifice and they quite willingly paid the trusted person a fee for his services, for under these conditions of mere safe deposit there could not be any profit to the custodian arising out of the actual handling of the money. A circle of customers of this type made the business a profitable one, and moreover enabled the custodian both to reinforce the strength of his safe-place and to purchase slaves, or hire guards, whose duties were continuously to watch and protect the stored wealth of his increasing clientele.

Transfers of Money

The second class of business mentioned, that of transferring money to and from distant places, was the corollary of the establishment of these bankers (although they had not yet acquired that designation) in many of the larger trading cities. If a merchant had to make a payment to another in a distant town he could of course take the bullion or money himself, or send it by a servant, and so deliver it directly to his creditor. But this very likely involved a long and perilous journey. The remitter therefore resorted to the banker and desired him to effect the operation on his behalf. The required amount of money having been handed over, the banker would probably give in exchange an order in the form of a letter addressed to a brother banker, being his correspondent or agent in the other city, desiring him to pay to the specified person the stipulated amount of

silver or gold as the case might be. This letter was the earliest form of that mercantile instrument called a bill of exchange which was to become so important in foreign and domestic trade in modern as well as in medieval times.

Naturally, the banker required some remuneration for his services in effecting remittances, the charge for which would be governed by the cost of sending the gold or silver by a messenger who would possibly have to be accompanied by an armed guard if the journey were hazardous. If several such remittances could be sent by the banker at the same time so much the better for all parties, for the expenses would be spread over the several sendings and the cost to the customers individually could be reduced.

It could conceivably happen that two or more transfers of money between the same two towns would be required at the same time, or shortly afterwards, but in opposite directions. If these transfers were also entrusted to the medium of professional bankers, it is easy to see that the transactions could be 'married' by the first banker and his opposite number in the other place.

For example, a banker in Babylon receiving a number of shekels of gold from Marduk for transfer gives in exchange a letter addressed to his Nineveh agent desiring the latter to pay the same amount to Tukulti. If the Nineveh banker at about the same time happens to be requested by Tiglath-Pileser to transfer a similar amount to Nabonassar in Babylon, it is obvious that no movement of gold whatever between the two cities is required. The Babylonian banker simply hands over the gold he receives from Marduk to fellow-citizen Nabonassar, whilst in Nineveh, Tiglath-Pileser's gold is similarly handed over to Tukulti. The two bankers make very useful profits from their charges for special messengers and guards who, in the outcome, never had to set out with their respective treasure-laden camel

trains. The letters, or bills of exchange, as well as the bankers' own advices to each other will have been sent to their respective addressees by an ordinary runner, public messenger, or other inexpensive mode of dispatch.

Even if the aggregate transfers in opposite directions did not coincide as to amount it would only be necessary to dispatch the difference in the one direction, thus saving no little expense. It is even possible that the one banker would be quite content to leave the difference in his favour outstanding with the other, until it became settled by subsequent transactions, or maybe by a grand final dispatch of the gold or silver required to settle the net differences resulting from a long series of mutual operations.

In Babylonian days communications were written with a stilus upon clay-tablets. One may readily imagine the tablet dispatched by the Babylon banker to a Nineveh confrere with a remittance in final settlement. The translation might read something like the following:

'To Ashburni-pal in the City of Nineveh greetings. Behold the time hath come when dealings between thee and me shall be accounted for and I send by my servant Kashshu two hundred shekels of gold whereby our accounts shall be settled. Thou wilt have paid at my behest to Shalmeneser, of gold two hundred shekels, to Nabu-dan, fifty shekels, to Esarhaddon two hundred and fifty shekels, the sum of these being five hundred shekels. Thou hast commanded me to pay Zabum, of gold one hundred shekels and to Khammurabi, two hundred shekels. This have I done and now dispatch the sum due to thee. I pray thee give me tidings of thine agreement and of the safe coming of my servant with the gold.'

The Egibi Tablets

The earliest records of banking which have come down to us from the ancient past show that a firm named Egibi & Co. was founded in Babylon during the reign of Sennacherib, about 700 B.C., where it flourished

for more than a century and a half. A large number of baked-clay tablets, known as the Egibi tablets, are to be found in the British Museum, and testify to the importance of the firm in the life of the period. They relate to the sale of property, dealings in slaves, guarantees, and many other commercial transactions. The most interesting relic to us, however, is one unearthed along with hundreds of others by Arabs searching for antiquities near the ruins of ancient Babylon, some sixty years ago. This particular tablet or brick proved to be the earliest draft or bill of exchange yet discovered. Upon it was an order by these bankers addressed to their correspondent in Orchoe requiring the latter to pay a sum of money to a designated payee. The following is a translation of this fascinating relic:

‘Four minas fifteen shekels of silver to Ardu-nana son of Yakim upon Mardukabalussur son of Mardukabalatirib in the town of Orchoe—Mardukabalatirib will pay in the month of tebet four minas fifteen shekels of silver to Belabaliddin son of Sennaid. Our, the 14 arakh-samma in the second year of Nabonidus King of Babylon.’

Then followed the names of various witnesses.

It will be observed that Ardu-nana had paid to Egibi & Co. four minas fifteen shekels of silver with a request that the amount was to be transferred to Orchoe, there to be paid to Belabaliddin. Egibi’s therefore instructed their Orchoe correspondent Mardukabalussur son of Mardukabalatirib to perform the transaction on their account. Moreover, it was not merely a simple order for a payment to be made upon demand, but it was drawn payable at future date, in the month of tebet, thus precisely resembling in form our modern bill of exchange.

These tablets had to be baked immediately upon execution in order to preserve them and, most probably, to prevent alteration or forgery, and therefore no subsequent endorsement of the payee was possible. The

name of the payee was consequently sometimes omitted and the draft or bill then presumably would be payable to the bearer of the tablet.

It was this process of baking which prompted an author on banking subjects, writing upon these remarkable relics of Egibi & Co., humorously to suggest that perhaps here lay the origin of the modern phrase 'cooking the books.'

Money-changing

Turning to the third type of banking, we know that in Biblical times the business of money-changing was a commonplace in the larger cities, where merchanting took place with distant countries and where travellers were accustomed to visit. Such bankers often set up their benches and balances in the market-places and even inside the temples, both being centres where likely customers tended to congregate. The business of these people would consist of buying and selling gold, silver, and foreign coins. They would be expert in detecting base metal, quick in estimating the equivalents of one currency in terms of another, keen in driving a hard bargain and doubtless, in view of their reputation, ruthless in taking advantage of their customers' ignorance or slow-wittedness. In fact we read in the New Testament that Christ scourged some representatives of the profession out of the Temple in Jerusalem, the while He anathematised them as desecrators of the holy place which they had 'made into a den of thieves.' Their unsavoury character was well recognised all over the East in that period and they were correspondingly disliked.

Banking in these three phases continued with little variation for many centuries. It is true that Marco Polo and Sir John Mandeville stated that something akin to an inconvertible note was in use in China at the times when their famous, not to say fabulous, journeys took place. It will be recollected that Polo lived at

the Court of Khubla Khan from 1275 to 1284, whilst Mandeville visited Tartary in 1322. The latter wrote:

'The Emperour may dispenden als moche as he will withouten estymacioun. For he dispendeth not, he maketh no money but of lether emprented, or of papyre. . . . For these and beyond hem thei make no money, nouthur of gold nor of sylver and therefore he may despende ynow and outrageously.'

It is unlikely that these two invented their stories in this connection, romancers though in other matters they undoubtedly were, and in the case of Mandeville unreliable to the last degree. We must assume therefore that paper or leathern money was in common service in Cathay, either in substitution for, or in addition to, metallic money, but we have no details as to the genesis there of this form of currency. There is, however, evidence that abuse of the system resulted in it becoming discredited and being abolished in the sixteenth century. Certain it is that even the memory of the practice completely died out, for Gabriel de Magaillans, a Jesuit who lived in Peking in 1668, stated that nobody there had any recollection of paper money such as had been mentioned by Marco Polo. The highly important development of this form of money which took place in Europe much later evidently owed nothing to any experience which the Eastern people may have had.

The Jewish Moneylenders in England

Of the practitioners of banking and money-changing, the Jews racially and temperamentally were the most capable, and it is not surprising that large numbers of them followed the Normans to England after the Conquest and became powerful and wealthy in the exercise of their trade or profession. We know that the Norman kings resorted to them for financial assistance on numerous occasions.

For two centuries the Jews remained undisturbed in their activities, and settled in colonies called Jewries in the large cities; in London, Old Jewry is the street

in which they lived. In the year 1290 such an anti-Semitic pogrom flared up as periodically has occurred in every country during medieval times. Edward I issued a decree of banishment and, with a thoroughness of which some present-day governments could perhaps be envious, these unfortunate Jews were stripped of all their possessions and driven forth with cruelty and opprobrium across to the Continent. History has it that one time-serving sea captain, shipping a batch of such passengers who had been allowed to take some of their possessions with them, disembarked the luckless people at low tide on one of the sandbanks off the Thames Estuary and left them there to perish. He returned to London with their belongings; whether to the King's profit or his own does not emerge.

It is of interest to note that, after this thoroughgoing dispossession and expulsion, the Jews were not allowed to resettle in England for four hundred years. In fact, it was Oliver Cromwell, in the late seventeenth century, who relaxed in their favour the rigid prohibition which had hitherto been maintained.

The Lombards

The place of these Jewish moneyers was taken by Italian merchants who were dubbed Longobards or Lombards, whether because they originated in Lombardy or because they wore long beards it is difficult to say. We have an ever-present reminder of them, for the name Lombard Street is derived from their pseudonym, since it was in that thoroughfare these merchants assembled in order to carry on their business, which they conducted upon benches or tables in the open street. To the Italian word 'banco,' signifying a bench, we are said to owe the term bank; if this is correct, we find the direct connection between the name of the profession and the early method by which it was carried on, for the banker was a person who carried on his business from a bench. They set up their sign of the three

golden balls of the Medici, or, as some say, the sign of the three money-bags of St Nicholas, the patron saint of merchants. These Longobards who settled in London had extensive foreign connections, and although they were primarily concerned in foreign trade the very nature of their business tended to make them also interested in transfers of funds. For example, they were the Agents to the Papacy and, as such, collected the revenue from the English benefices, remitting it by their bills of exchange to Rome. They were the more easily able to carry on this remittance business by reason of their connection with the wool trade between Italy and England. These merchant-bankers carried on their activities for at least one hundred and fifty years.

The Goldsmiths

Perhaps partly concurrently with the Lombards, but certainly as their successors, there existed in London the goldsmiths. We find that the Goldsmiths Company, one of the guilds of which so many still exist in the City of London, was incorporated under a charter of Richard II in 1392. It would be natural for artificers in gold to be connected with banking, since at that period the latter profession was so largely concerned in the metal. However, the merchants and nobility gradually acquired the habit of entrusting their money as well as their plate to these goldsmiths, who were responsible citizens and sufficiently wealthy perhaps to remove any lingering doubts as to their integrity. This habit became the more confirmed since in the year 1640 Charles I, in sore need of Exchequer replenishment, seized some £120,000 belonging to merchants which had been deposited by them for safe custody with the Royal Mint. It is quite understandable that the citizens thereafter resorted less to a single public institution, which offered such easy opportunities to a needy monarch, and more to comparatively anonymous fellow-citizens of standing such

as goldsmiths, who could be relied upon to keep secret, as far as practicable, details of their own and their customers' wealth. Possibly here is the origin of that banking canon of absolute secrecy as to a customer's affairs which is so strongly characteristic to-day, even to the extent of denial to Government officials of information in individual cases which might, for example, assist the Inland Revenue in ascertaining the liability of a customer for income tax.

Notes evolve from Deposit Receipts

These goldsmiths were required by their customers to give a receipt for the deposits of money made with them. What was more natural than that these receipts should in course of time come to be regarded as the equivalent of the actual money deposited? They even came to be regarded as instruments of transfer, for custom gradually conferred upon them the attributes of negotiability. Thus we see that there had unconsciously evolved the equivalent of a 'note' which represented an actual deposit of gold so long as the goldsmith continued an honest custodian.

It is recorded that an astute goldsmith's clerk, observing that his master constantly held large sums in gold on behalf of customers who rarely withdrew it, perceived herein an opportunity of making money for himself. Being of doubtful morality, or at all events not above sharp practices, and meeting some needy merchant who required temporary accommodation, the clerk abstracted some of this 'idle' hoard of money and lent it to the merchant at a goodly rate of interest, hoping to obtain repayment and replace the money before the shortage was discovered.

The Goldsmiths' Loans

Whether this story be apocryphal or not, the fact remains that the goldsmiths, relying upon their reputation

as honest and wealthy men, later found a similar method of great service to the trading community and of considerable profit to themselves. They made no secret of the practice; on the contrary, they began to offer payment of interest to all who cared to deposit their spare cash with them, or at least made no charge for keeping the funds. Like the tricky clerk, they observed that only a small proportion of the depositors required their money back again at any one time and they were thus enabled, without serious risk, to lend out to reliable borrowers one-half, three-quarters, or even more of the deposits entrusted to them. Their reputations stood so high in the estimation of the City merchants and wealthy classes that increasingly large sums were deposited with them for safe-keeping at a fair rate of interest. It was, of course, possible for a depositor himself to make loans to borrowers, and if he decided so to do he would draw from the goldsmith the requisite cash. Alternatively he might pass over the deposit receipt direct to the borrower, who in turn would have the choice of drawing the cash from the goldsmith or of passing on the receipt to *his* creditor. In this manner it was possible for the deposit receipt to circulate from hand to hand amongst traders without any actual presentation to the goldsmith for encashment.

In practice, however, the depositor generally would leave short-term lending to the professional, who was in a better position to know the borrower's means, character, and financial circumstances, and less likely to make a bad debt; and, since the goldsmith was now willing to pay interest to his depositors, the habit of leaving to him the province of lending was confirmed.

Now that the goldsmith's receipts had come to be regarded in the mercantile world as the equivalent of money, it is obvious that, when a would-be borrower successfully applied for a loan, the goldsmith-banker would endeavour not to hand over cash in respect of the accommodation but instead would pass out his

receipts or 'notes,' which then circulated amongst the public for a longer or shorter period, varying with the activity of trade and the reputation which he enjoyed. The goldsmith would continue to issue such notes until the total outstanding was three, four, or more times the value of the gold deposited with him and any he personally possessed; the proportion of issues to cash would of course be fixed according to the prudence of his ideas as to the probabilities of deposit withdrawals. This probability would naturally be lessened if a greater proportion of the deposits were left with him for a definite period, as contrasted with deposits repayable on demand. He had hit upon the idea of increasing the rate of interest for 'time' deposits and the longer the fixture the higher was the interest allowed to the depositor by him.

The Pyramid of Credit

We have now arrived at a time when money, as represented by notes, was several times the amount of the actual gold or silver which formerly would have been the only currency in circulation. The earliest form of a pyramid of credit based on gold had thus come into being. It will have been observed that the expansion of credit through the additional note issues had come about as a result of merchants' requests for accommodation, usually in connection with trade requirements. The prudent banker preferred to grant assistance to this class of borrower because of the greater likelihood of repayment resulting from the money constantly being turned over. Consequently, the bankers' favourite method of making advances was to purchase or discount the merchants' bills of exchange. As we shall see when we discuss these instruments, bills usually arise out of the buying and selling of merchandise, they have at least two names responsible for due payment and, most important, the date of payment is definitely fixed.

The Goldsmiths as Bankers

Many of the goldsmith-bankers gradually abandoned the goldsmith's trade and concentrated upon the purely banking side of their business, as, for example, did Sir Francis Child, the founder of Child's Bank, some time before the year 1670. In some quarters they were known as 'keepers of runnyng cashes,' in fact the *Little London Directory* of 1677 so lists them. (The running cash notes were notes issued as mentioned above, without being specifically secured or backed by actual cash.) These private bankers, as we must now regard them, flourished greatly, particularly in the last quarter of the seventeenth century; their businesses have in many instances survived into our own times and have been absorbed into the present-day banks. Child's Bank still carries on business under the 'sign' of 'Ye Marygold' in Fleet Street, but now as a branch of Messrs Glyn Mills & Co. Hoare's Bank, also in Fleet Street, is still an independent concern under the old sign of the 'Golden Bottle.' Sir Richard Martin, under the sign of 'Ye Grasshopper,' carried on the business which to-day is Martins Bank Ltd. That of Humphrey Stocks (Pepys' 'little banker'), under the sign of the 'Black Horse' in Lombard Street, is to-day part of Lloyds Bank Limited; hence the crest of this great modern bank. Pinckneys, under the sign of 'Ye Three Squirrels,' later became Goslings and thence passed into Barclays Bank Limited. Many others could be cited, not only in London but in the provinces, which show the connection between the former goldsmiths of nearly three centuries ago and the colossal banking concerns of to-day.

Chapter III

THE BANK OF ENGLAND

PUBLIC banks made their appearance on the Continent much earlier than in this country where, as we have seen, Jews, Lombards, goldsmiths, and their successors functioned as private or small partnership concerns.

It is difficult to ascertain the actual dates of the foundations of these early European state banks as the authorities are so widely at variance. The institutions have all passed out of business long ago and their records seem to have been irretrievably lost. It appears fairly definite however that the first public bank was the Bank of Barcelona, which is believed to have been established in 1401. It conducted a deposit business and discounted bills for the Catalonian merchants. The next bank, apparently, to be established was the Bank of St George, Genoa, which was founded in 1407. This concern however commenced as a species of finance house operating solely to obtain loans for the Government; it did not transact banking business, as the term is now understood, until 1675. The Banco di Rialto of Venice was founded in 1584; a belief that it commenced in 1157 is erroneous. The Bank of Amsterdam was founded in 1609, as was in 1656 the Bank of Stockholm.

During the reigns of Elizabeth, James I, and both Charleses, as well as under the Protectorate, many schemes were proposed for the foundation of a bank for England similar to these successful Continental institutions. The plans were generally mooted in pamphlets, many of which exhibited most extraordinary ideas for the raising of the necessary capital. One scheme, for instance, seriously proposed that a weekly one-meal day should be officially instituted to enable householders to subscribe to the bank a halfpenny weekly

on behalf of each member of his family; that persons should pay to the bank ten shillings for a 'mortuary' on 'departing this life'; that taxes should be levied on the Livery Companies' feasts and on the earnings of lawyers practising in the courts. All the proceeds arising from the execution of these ideas were to be handed to the projected bank.

The reasons advanced for the proposed banks were usually the financing of the Government and the assistance of trade. Several ill-starred ventures were actually launched but soon came to untimely ends, with resultant distress to their unfortunate participants.

The Tunnage Act of 1694

It was not until the reign of William and Mary that a Scot named William Paterson had his scheme for the formation of a 'Bank of England' adopted by the Treasury. His proposals aimed at lending to the Government the funds raised as capital for the Bank. Paterson, more lucky than earlier propounders of such schemes, happened to launch his proposals at a time when the Government sorely needed financial assistance to prosecute the war with the French. William III under the advice of one of his ministers, Montagu, assented to the plan, and in the year 1694 the Tunnage Act was passed, authorising amongst divers other matters the incorporation of an institution to be entitled 'The Governor and Company of the Bank of England,' the capital of which was to be £1,200,000. This curious bill granted to the Crown duties upon 'tunnages of ships and vessels and upon beer, ale, and other liquors,' and these duties were to secure 'certain recompenses and advantages in the said Act mentioned, to such persons as shall voluntarily advance the sum of fifteen hundred thousand pounds towards carrying on the War against France.'

The Bank is founded

The Bank's capital of £1,200,000 was quickly promised by a public anxious to become shareholders and the

first instalment soon paid up, the Government being given credit for the full sum, which it disbursed as required. The capital thus invested in Government Funds, being part of the £1,500,000 authorised under the Act, became secured by the tunnage duties. This was excellent business for the proprietors since an annual sum of £100,000 was to be so appropriated, representing 8 per cent. interest and £4000 a year remuneration for the management of the Debt by the Bank.

The Bank, under its statutes, was to be permitted to buy and sell bullion, to issue transferable bills and deal in bills of exchange, and to lend money on securities, including merchandise, although it could not itself buy and sell merchandise. It was not permitted, however, to raise further capital to lend to the King unless sanctioned by Parliament, this being a clause designed to keep the control of the finances in the hands of the House of Commons. The Act was passed despite violent opposition from political opponents, the goldsmiths, and other interested parties.

The Court of Directors passed resolutions governing the mode of conducting business. At the first meeting it authorised the Cashiers (1) 'to give out Running-Cash-Notes,' (2) 'to keep an account with ye creditor in a Book or Paper of his owne' (at first sight it may appear that the directors were being thrifty in allowing a customer to provide his own pass-book or stationery, but in actual fact all it means is that the officials were permitted to give him a personal record for his own use in addition to maintaining the general cash account of the Bank, usual at that time, from which individual holdings had to be disentangled), (3) 'to accept Notes drawn on ye Bank.' The third meeting of the Court passed other resolutions which are interesting for the reason that they described the Running Cash Notes as 'Notes payable to bearer'; this of course is the essential attribute of the true bank note.

By the end of 1694 only 60 per cent. of the capital had been called and paid up, whilst the Government had drawn off the full £1,200,000 in notes and 'sealed bills.' The latter were printed instruments bearing the Bank's seal, assignable by endorsement, and were interest-bearing. In effect they were promises to pay the specified sum at a definite future date together with the interest (originally at twopence per cent. per diem). Upon maturity and presentation to the Bank they were paid by notes, or perhaps by the issue of fresh sealed bills. It will be seen that the Bank, so far, was carrying on a similar business to that of the goldsmith-bankers and on a very large scale for those times.

Engraved Bank Notes

The Bank of England appears to have been the first institution in this country to issue engraved bank notes, and this innovation was instituted probably in the first year of the Bank's existence. The amount and the signature however had to be filled in by hand, and it was not until many years later that the complete notes were engraved in various denominations.

The Bank and the London Merchants

The work of the Bank was not finished once the loan to the Government was effected and notes and sealed bills had been issued in payment of the drawings of the Treasury. The merchants of London at once commenced business with the new institution and opened accounts, paying in to their credit guineas and silver coinage as well as goldsmiths' notes, which latter the Bank presented daily to the issuers for encashment, receiving gold coin to the equivalent value. Many sought accommodation against the deposit of merchandise, and against other forms of security which were both acceptable to the Bank and conformable with its statutes. Again, when in need of ready money, they requested the Bank to purchase from them their holdings

of bills of exchange, that is, the promises of other merchants to pay specified sums of money upon future dates. The Bank was generally willing to do this and, provided the names thereon were approved, to give the face value of such bills subject to the deduction of interest at a stipulated rate on the unexpired period. This interest is called the 'discount' and the process of purchase the 'discounting' of the bill.

The cheque had not yet become the all-powerful instrument that it was to prove a century or so later, although it was by no means uncommon even long before the foundation of the Bank of England. Withdrawals by merchants from their accounts other than by guineas and silver coins were therefore usually taken in the notes of the Bank. Again, if the Bank purchased gold or bullion it paid the seller by means of its notes or by a credit to an account in his name, whence it could in due course be drawn off in notes.

A moment's consideration will show that whilst the Bank had liabilities to its depositors on account, to holders of its notes and sealed bills in circulation, and to its proprietors in respect of their capital together with the accumulated profits, it had in the aggregate an equal amount in assets consisting of gold coin and bullion, silver, loans owing by borrowers, bills of exchange discounted not yet fallen due for payment, and lastly the Government Stock in which it had invested its original capital. A balance sheet of this earliest period unfortunately is not available as there was no compulsion upon the Bank to publish any figures showing its position, nor did it see fit to take the country into its confidence.

We have seen in the preceding chapter that the goldsmiths created a pyramid of credit, in the form of notes issued, which was only backed as to a small proportion of the amount by gold and silver. Similarly the Bank of England issued notes to the extent of several times its holding in cash, the Directors being the sole arbiters

as to the relative proportions to be maintained by their officials.

The Proportion

It is perhaps apposite at this stage to give a practical explanation of the working of this proportion, and to do this we shall consider an imaginary bank which might have started in 1694 (but did not) and give figures which, let it be emphasised, are purely fictitious. In December 1694 only a percentage of this bank's capital of £1,200,000 had been called up. Let us assume that the amount of £720,000 had been paid in by the proprietors in gold, or in goldsmiths' notes which the bank had promptly encashed. At the end of that month the imaginary bank had lent a visionary government the entire amount agreed, viz. £1,200,000, which amount we assume to be taken in the bank's notes. A balance sheet taken out at that stage would have read as follows:

THE BANK OF ALBION			
<i>Liabilities</i>		<i>Assets</i>	
Proprietors' Capital,		Government Securi-	
Paid up	£720,000	ties	£1,200,000
Notes in circulation	1,200,000	Gold and bullion .	720,000
	<hr/>		<hr/>
	£1,920,000		£1,920,000
	<hr/>		<hr/>

We see then that there would have been a gold backing of £720,000 to support a note issue of £1·2 millions, or 60 per cent.

Let us next assume that merchants in need of ready funds had successfully applied to our bank for loans aggregating £240,000 which they had withdrawn in notes. The balance sheet would now read:

Proprietors' Capital,		Government Securi-	
Paid up	£720,000	ties	£1,200,000
Notes in circulation	1,440,000	Other Securities .	240,000
		Gold and bullion .	720,000
	<hr/>		<hr/>
	£2,160,000		£2,160,000
	<hr/>		<hr/>

The proportion of gold to circulation has now fallen to 50 per cent.

To go a step further, if the bank next purchases £100,000 worth of gold and hands out the same amount in notes, the 'gold and bullion' is now increased to £820,000, whilst the 'notes in circulation' stand at £1,540,000, thus making the proportion 53·2 per cent.

In order to arrive at a balance sheet more in keeping with parallel real circumstances we next assume that current accounts are opened by customers paying in gold to the extent of £180,000. We now arrive at this position:

Proprietors' Capital	£720,000	Government Securities	£1,200,000
Customers' Deposits	180,000	Other Securities	240,000
Notes in circulation	1,540,000	Gold and bullion	1,000,000
	<hr/>		<hr/>
	£2,440,000		£2,440,000
	<hr/>		<hr/>

The proportion is now improved to 64·9 per cent. If one of the customers wished to withdraw £50,000 he might take it in notes, in which case the 'deposits' would be reduced and the 'notes issued' increased by that figure. If however he elected to take gold both sides of the balance sheet would be affected. The proportion would be reduced by the switch-over into notes and to a rather greater extent by the gold loss.

Enough has been said to make the deduction clear that if the bank wishes to increase the proportion the simplest way to ensure it is to insist upon repayment of its loans or to let the bills of exchange be paid in cash when they fall due, whilst declining to discount fresh bills offered by customers. For by these means the 'other securities' are reduced and the gold is increased, or alternatively 'notes in circulation' are decreased should the repayments be made in the bank's own notes; either case is favourable to the proportion. On the other hand, if the bank considers that the proportion

is unnecessarily high, further loans or discounts will result in a reduction in the percentage.

When the initiative, however, is on the side of the depositors and note holders, and they demand gold in exchange for their balances or notes, it is obvious that if the process goes far enough—in times of panic for instance—there could come a time when all the gold or silver coin had disappeared and there still remained customers and note holders vainly clamouring for satisfaction.

This question of the gold proportion has been discussed at some length in order to assist the reader to understand the phenomena of over-issue or under-issue causing the many crises which the Bank of England (to return to our narrative) recurrently experienced during the next two centuries.

The Bank of England was born in troublous times. The war with France, the wretched state of the currency, which included an enormous quantity of clipped, 'sweated,' and counterfeit coins, the bad harvests and political intrigue, had all conspired to make the work of the new institution as difficult as it is possible to conceive. Nothing but the honesty, integrity, and will-to-succeed of the Directors pulled the concern through those early years. These qualities appealed strongly to the merchants of the City and the support and confidence which they gave in return were deciding factors in its successful survival.

The National Land Bank in Opposition

Notwithstanding this support, the Bank had not long been in existence before it had to meet its first crisis. Proposals had been made for the establishment of a rival bank which was to be called the National Land Bank. The scheme was strongly supported by the Tories, who were always very antagonistic to the Bank of England, essentially a Whig institution. An Act was passed in April 1696 authorising this flotation,

the capital of which, £2,564,000, was to be lent to the Government at 7 per cent. and secured by a tax on salt and certain other commodities, very much on the lines of the Tunnage Act. The Bank of England unsuccessfully petitioned against this infringement of what they considered their implied monopoly and vainly offered to lend the money themselves on reasonable terms to the Government. As it turned out, however, the Land Bank flotation was a complete failure, although severe injury had meanwhile been done to the credit of the Bank of England.

The Debased Coinage

The re-coining measures following upon a Proclamation at the end of 1695 proved an even stronger blow to the fortunes of the established Bank. Contemporary evidence shows that the silver coins had been so maltreated, notwithstanding vicious penalties against persons found guilty of the practices, that their weight was, on average, little over half the full normal standard. Moreover there were large quantities of copper, brass, or iron coins silvered over to resemble the real thing. This evil was taken in hand early in 1696 by the Government, who enacted that new coins were to be issued at par in exchange for the clipped ones, a proceeding which cost the country £2.7 million in making good the deteriorated currency. The Bank, possibly at the instance of the Government, promised to receive the old coins at par and doubtless, although accounts are vague upon the subject, issued their own notes in payment thereof. At all events, it is certain that a dangerously high level of paper was in circulation in relation to the backing of gold and available good coinage. Unfortunately for the Bank, the Mint was inordinately slow in turning out the new money. Consequently the demands of note holders, made nervous by the fall in the Bank's credit through the Land Bank proposals, and accentuated by the ill will of many of the goldsmiths, who sought to

turn the occasion to the detriment of their powerful rival, soon resulted in the Bank finding itself desperately short of sound money, and it was compelled to suspend cash payments. Precisely the situation mentioned earlier in this chapter had arisen: the note encashments had proceeded so rapidly as a result of panic that there was little coin left with which to satisfy the further note holders who were eager to exchange into hard money.

The circumstances were due to no fault of the Bank and the public were asked to accept payment of 3 per cent. of their demands per fortnight until the situation eased. Luckily, towards the end of the year, the Mint output had been speeded up and the crisis was over. As usual in such circumstances, as soon as cash was known to be available few wanted it; at all events no further pressure seems to have been experienced.

Suspension of Cash Payments

This was the first suspension of cash payments, and there have been many other occasions since then when this actually occurred or threatened to ensue. It is interesting to compare the position of a great public institution such as the Bank of England with that of a small private concern. In similar circumstances of non-ability to discharge his obligations in cash a goldsmith would have been held to have failed, and his business in all probability would have been brought to an end even though he might have been perfectly solvent given a little time in which to realise his assets. But the Bank of England perforce carried on, notwithstanding that its notes were 'inconvertible' into cash. It would never have done for the Government to allow the principal issue bank to fail, and except in 1797 when, as we shall see later, large over-issues of credit caused the suspension, nobody was much the worse, for the notes generally kept their value despite the absence of convertibility.

The difficulties of the dilatory coinage having been

overcome, and no threat of opposition from rival promotions being present, the Bank was enabled for a year or two to consolidate its position. The Government now requiring further loans approached the Bank Court for assistance, whereupon the latter very delicately hinted that since Parliament in its wisdom had thought fit to withdraw the duty on tunnage when the Land Bank Act was passed, and so impaired the credit of the Bank, they felt they could not raise the sum of two and a half millions required. Negotiation however smoothed away difficulties, and the Bank Act of 1697 authorised an increase of the Bank's capital and an extension of its Charter until 1711. Moreover this measure categorically asserted that no other institution of the nature of a bank should be permitted by Act of Parliament during the continuance of the Corporation.

The Monopoly of 1709

It is impossible here to enter very deeply into the incidents of the next hundred years but the main points must be mentioned. The capital of the Bank was increased from time to time on the various occasions of Government borrowings, and the directors very shrewdly managed to extract a series of extensions of the Charter, often long before the actual expiry of the existing one. An abnormal demand for cash in exchange for notes (commonly called a 'run' on the Bank) occurred in 1709 as a result of Jacobite intrigue and upon rumours of a French invasion in the Stuart interest. The goldsmiths once again seized the opportunity to try to ruin their powerful competitor, but the assistance of Whig nobility and the merchants overcame the danger. In the same year the Bank Charter was renewed, the capital was greatly increased, and substantial loans were granted to the Government. In return the Bank was given a large measure of monopoly in England (not in Scotland or Ireland) for it was expressly prohibited under the Act for 'any body corporate or persons united in partnerships

exceeding the number of six to borrow or owe money on bills payable at demand or at any less time than six months.' Since at that time banking seemed to be essentially a question of note issue, it appeared to be, and was generally accepted as, a complete prohibition of joint-stock banking.

The South Sea Bubble

An event of great importance in the financial history of England was the collapse of what came to be known as the 'South Sea Bubble.' In 1711 a company was chartered and made loans to the Government in return for which the monopoly of trading in the South Seas (the Pacific) was conferred upon it; hence its name of the South Sea Company. In 1720 the Company offered to take over the whole of the National Debt, nearly £31 millions, in return for an annual payment of 5 per cent. and to give the Government £3½ millions for the privilege. The Bank of England, fearful for its position, offered to do the same thing but raised the premium to £5 millions. Fortunately, as it ultimately turned out for the Bank, the South Sea Company overbid it at the figure of £7½ millions and secured an Act permitting the deal. This started a mania of speculation and the price of the South Sea £100 shares soared in a few months to £2000. Upon other wild-cat schemes being promoted the Company brought actions against the persons propounding them on the grounds of illegality. Injunctions were obtained which only had the effect of pricking the bubble of speculation and the South Sea leaders in lunacy, as a result of their greed, found the price of their own shares falling on the market. Notwithstanding the wildest promises from the directors of a 30 per cent. dividend for 1720 and 50 per cent. for the year following, everyone tried to 'cash in,' only to discover the disastrous difference between real values and the fictitious ones at which they had bought. General ruin ensued, and although the Bank promised to help the South Sea

Company by credits, a run forced them to withdraw from the arrangement before it had actually been ratified. It was during this run that the device of paying out in sixpences and other small silver coins was adopted, for the time consumed in counting out the money greatly slowed down the withdrawals. Another amusing method of staving off an anxious public was to organise a kind of stage army of customer-friends of the Bank who drew out large sums. These people handed it to others outside who promptly came back and paid it in again. The money had thus to be counted twice over and the double operation was most useful in keeping at bay those with real demands, the more so as the friends of the Bank were always served first.

The subsequent inquiry into the affairs of the South Sea Company revealed widespread bribery and corruption, in which Ministers of the Crown, including the Chancellor of the Exchequer, were involved. The subsequent clearing up of the matter involved an increase in the capital of the Bank which, under Government sanction, raised funds to assist the South Sea Company to reconstruct on a moderate scale, and to mitigate at least some of the hardships suffered by its shareholders.

In 1722 a wise innovation was made by the Bank directors who decided to build up a fund out of part of the annual profits. This fund, called 'The Rest,' was designed to provide a reserve to meet emergencies and to equalise the dividends. Up to that time the profits had been fully distributed by the annual dividend payments.

Commercial crises occurred at fairly regular intervals in 1763, 1772, 1783, and 1793, generally due to speculative movements with resultant private bank failures. The monopoly of 1709, which was confirmed by the Act of 1742, was not handled by the Bank of England entirely with wisdom, for it took no steps to establish branches in the country and, as its notes were

not popular outside London, it was left to any small trader (or partnership not exceeding six members) to start a bank and to issue notes. These puny concerns went down like ninepins whenever a crisis occurred, and they were a constant source of weakness as well as the cause of serious distress, alike to commercial and private interests.

The Suspension of 1797-1821

In 1797 occurred the most serious of these crises. The Napoleonic wars were in full force and the rumour of a landing of French troops caused a run on the banks. For some time the Government under Pitt had pursued a policy which involved paying huge subsidies to European allies in addition to its own heavy expenditure. Constantly recurring demands on the Bank of England for loans and the resultant drains of gold to the Continent had reduced the cash holdings to a dangerously low level, notwithstanding the protests of the directors to the Prime Minister. Finally, in February, the Privy Council was compelled to make an order suspending cash payments. The Bank of England sought for and obtained permission to issue notes for £1 and £2, the lowest limit previously authorised having been £5. Additionally, in order to relieve the problem of small payments, a large number of Spanish Carolus dollars, which had been captured at sea, were issued at four shillings and ninepence each, after having the effigy of the Spanish Monarch overstamped with a small impression of the head of George III. This issue prompted some humorist of the period to write:

‘The Bank to make their Spanish dollars pass
Stamped the head of a fool on the neck of an ass.’

Lèse-majesté in those days evidently was not reckoned a very serious offence. The need for the extraordinary proceeding, as it appears to us nowadays, of issuing an actual foreign coin for domestic use was due to the time

taken in those early un-mechanical days to design and complete the steel dies and to turn out new coins, which were made partly by a hand process, the impressions being stamped by (literal) horse-power. It was not until some years later that Boulton of Birmingham, the partner of James Watt, introduced steam-power stamping machines.

The suspension of cash payments continued long after Napoleon was finally overthrown in 1815 and peace had been declared, although a partial attempt at resumption occurred at the end of 1816 and in the spring of 1817.

A committee of Parliament in 1810, called the Bullion Committee, had issued a report which attributed the loss of gold leading to the suspension of 1797 and the prevailing high prices to over-issues of credit by the Bank of England and the country banks. This dictum the Government, the Bank, and the commercial community strongly denied, and the recommendations of the Committee were turned down. After a series of failures of country banks in 1814 and 1815 the paper price of gold fell heavily, thus justifying the conclusion of the Bullion Committee as to the former over-issue. The reduction in credit by reason of the disappearance of the notes of the insolvent banks, with resultant enhancement in the value of the paper pound as represented by the remaining sound issues, had made gold less in demand both for paying debts abroad and for hoarding at home, thus rendering possible the partial resumption of cash payments in 1816 mentioned below. The reader may possibly have difficulty in reconciling cause with effect in this statement but perhaps the matter will be clearer after later chapters have been studied.

Another spate of issues by the Bank and the country banks however caused a further rise in the price of gold in 1818, and a fresh committee was appointed to examine the position. This body came to the same conclusion that their predecessors of 1810 had reached, and this time the Government and the commercial world were in

full agreement with them. Parliament decreed by the 1819 Act that the Bank should resume payments in gold at prices falling by steps until the former statutory figure of £3, 17s. 10½d. per ounce should be reached. Government borrowings, which always necessitated fresh note issues, were to be restricted and subjected to strict Parliamentary control. In the event, the Bank of England resumed full cash payments in 1821, two years earlier than the date laid down by the Act.

A fresh mania of speculation induced by three plentiful harvests and booming trade conditions resulted in another crisis in 1825 with a very severe drain on the Bank's cash resources. As a result the Act of 1826 was passed, which made a drastic alteration in previous practice. Sir Robert Peel voiced the growing belief that the restriction of note-issue banking in the provinces to concerns of not more than six partners, instead of allowing the formation of joint-stock organisations with large capital and strong resources behind them, was a cause of serious weakness. The old order had resulted in petty tradesmen, ignorant of the principles of finance, setting up banks which could have no stability, nor indeed any guiding principle other than the immediate personal profit of the proprietor.

The Reversal of the Monopoly of 1709

The new Act therefore reversed the monopoly given to the Bank of England under the Acts of 1709 and 1742, and permitted the foundation of more powerful concerns with the right to issue notes, provided however that they were situated outside the radius of sixty-five miles from London. An earlier permit allowing the Bank to issue notes of smaller denomination than £5 was withdrawn. The Bank had to defer to the feeling of Parliament on the question of the monopoly although it did so very unwillingly: it now decided however to open branches itself in the country, a proceeding which should have been effected a century earlier in view of the privileges

it enjoyed. Offices, therefore, were speedily opened in Gloucester, Manchester, Swansea, Birmingham, Liverpool, Bristol, Leeds, Exeter, Newcastle, Hull, and Norwich, in that order, followed some years later by Portsmouth, Plymouth, and Leicester. The Exeter office was closed when Plymouth commenced. No further branches have ever been opened by the Bank other than two in London, one of which in recent times was ceded to a Scottish bank.

The Bank of England Note is made Legal Tender

In 1832 a Committee of Enquiry was appointed to make recommendations with regard to the renewal of the Bank's Charter which was due to expire in the following year. The resultant Act of 1833 contained provisions which are of momentous importance in the banking history of England. The Bank of England note had hitherto no legal status as money; the acceptance of it was entirely optional on the part of the receiver and, if he so chose, he could refuse it in payment of a debt and demand coin. Henceforward it was to be legal tender for amounts over £5; that is to say, nobody could refuse to take it when so tendered in payment of a debt. The Act further strengthened the hands of the Bank in its regulation of credit by permitting it to raise the rate of interest above 5 per cent. if thought expedient when discounting bills having up to three months to run, although the still operative usury laws had previously prohibited a higher rate. The Government also repaid the Bank one-quarter of the money borrowed in the past, reducing the figure to £11,015,100, and at the same time drastically cut down the fee paid to the Bank for its services in managing the public debt. The Bank did not take cash in respect of the repayment of the Government debt and return it to the proprietors in the form of a reduction of capital. Instead, it accepted £4,080,000 3 per cent. Annuities, thus exchanging a book debt (that is, one which is solely evidenced by

a mere book entry) for a marketable security at a much lower rate of interest. The capital of the Bank remained therefore at £14,553,000, at which figure it was acquired by the Treasury under the Bank of England Act 1946.

Rise of the London Joint Stock Banks

Doubt had begun to be thrown upon the belief that joint stock banking was illegal within the sixty-five-miles radius. Legal opinion inclined to the view that although banks issuing notes were prohibited, yet those transacting purely deposit business, upon which customers drew by cheques, were perfectly valid. So far no attempt had been made to test the question, but it seems evident that there had been some undercurrent, for this new Act of 1833 specifically declared that such a bank was perfectly legal. The Bank fought against this affirmation but, as earlier in the case of the country joint stock banks, in vain. The momentous result of the Act was seen soon afterwards when the first of the great London joint stock banks was founded.

Another principle established by the Act was that the Bank must give returns of its figures to the Chancellor of the Exchequer and publish monthly in the *London Gazette* the average of the weekly liabilities and assets for the previous three months. The Charter was renewed until 1855 but Parliament reserved the right to determine it in 1844, should the Government by then have repaid its debt and given twelve months' notice of its intention.

Taking the provisions of this 1833 Act as a whole, it is evident that the Government was no longer 'in the pocket' of the Bank and that an attitude of independence from the domination of finance had arisen. That this was the case became increasingly manifest in 1844. Sir Robert Peel had become Prime Minister and he had very definite views upon the question of governmental control of note issue, which was still considered the main

attribute of banking business. Accordingly he gave notice that the Government intended to avail itself of the option to determine the Charter of the Bank in 1844 and made a renewal till 1855 dependent upon the acquiescence by the Bank in the proposals which became embodied in the Act of 1844.

The Significance of the Bank Act of 1844

Up to that time the Court of the Bank was the sole arbiter as to the proportion of gold considered advisable to be kept in support of its liabilities to the public. A working plan had been in operation internally for some years whereby the metallic reserve should be kept on a one-third basis. During the 1839 crisis this proportion, however, fell to a figure lower than one-sixth, owing to the persistent drain of gold abroad. Peel adopted ideas which had been proposed by Mr S. J. Loyd, afterwards Lord Overstone, which were primarily concerned with taking the question of the note backing out of the discretion of individuals and making it an automatic principle.

The Act laid down that note-issue banking was an entirely separate function from that of deposit banking and consequently the two departments of the Bank were henceforward to be separated. The Issue Department was to have £14 millions worth of securities transferred to it and to be permitted to issue notes thereagainst up to the full amount. This was called the 'fiduciary' issue. For every note issued over and above that limit gold coin and gold and silver bullion must be held, pound for pound, the silver being restricted to one-fourth of the value of the gold.

Existing banks were to retain their rights to issue notes but only up to a fixed maximum limit based upon their average circulation over a defined period. If any of these issues lapsed through bankruptcy, by surrender, by amalgamation with concerns having offices within sixty-five miles of London, or by fusion of banks which

brought their partnership numbers above six, the Bank was empowered to increase its fiduciary issue by two-thirds of such lapses. Incidentally the provision as to more than six partners was, to say the least of it, illogical in view of the rights of issue conferred upon country joint stock banks by the earlier Act. But the over-riding intention was to restrict issue by degrees to the single institution where it could be rigidly controlled under the provisions of the Act. This intention was singularly successful, for by 1900 the great bulk of the country issues had lapsed in one way or another. The last bank to surrender its note issue was Fox Fowler & Co., when it amalgamated with Lloyds Bank Limited in 1921.

The Bank Return

One of the provisions of the 1844 Act was that any person had the right to demand notes from the Bank in exchange for gold at the rate of £3, 17s. 9d. per standard ounce. Particularly important was a further duty imposed upon the Bank of publishing weekly a statement of its position. This Return became the compass by which the financial world steered its course in later years, for the movements of the figures indicated the tendencies as to changes in the interest rates.

It is of interest to refer to the first balance sheet of the Bank published after this Act came into force. It is dated 7th September 1844.

ISSUE DEPARTMENT

Notes issued . . .	£28,351,295	Government Debt . .	£11,015,100
		Other Securities . .	2,984,900
		Gold Coin and Bullion . .	12,657,208
		Silver Bullion . .	1,694,087
	<hr/>		<hr/>
	£28,351,295		£28,351,295
	<hr/>		<hr/>

BANKING DEPARTMENT

Proprietors' Capital	£14,553,000	Government Securities	
Rest	3,564,729	ties	£14,554,834
Public Deposits	3,630,809	Other Securities	7,835,616
Other Deposits	8,644,348	Notes	8,175,025
Seven-day and other Bills	1,030,354	Gold and Silver Coin	857,765
	<u>£31,423,240</u>		<u>£31,423,240</u>

M. MARSHALL (*Chief Cashier*).

It is unnecessary to explain these headings in any great detail; most of them speak for themselves. Of the £28 million of notes issued it will be observed that over £8 millions reposed in the Banking Department as a reserve against the liabilities to depositors, which consisted of £3.6 millions to Government departments, £8.6 millions to the general public including the banks, and £1.0 millions on remittance bills issued by the Bank. The Government debt of £11 millions represented the total of loans made to the Government by the Bank since its foundation less the repayment mentioned earlier; the 'Other Securities' of £2.9 millions in the Issue Department as well as the 'Government Securities' in the Banking Department of £14.5 millions, consisted of obligations of the British Government which had been acquired by purchase or otherwise. The £7.8 millions under the heading of 'Other Securities' in the Banking Department consisted of loans made to, and bills discounted for, the public, as well as some non-Government bonds held by the Bank. It will be realised that here the word 'Securities' does not carry its ordinary significance; to the Bank all assets other than notes and bullion are securities. Finally the 'Rest' was the balance of undivided profits which had been built up to the figure of £3.5 millions. The Bank never allows this figure to fall below £3 millions, and the fund acts as a nest-egg should extraordinary misfortune befall.

It seems to us nowadays remarkable that Overstone

and Peel so concentrated upon the necessity for securing the convertibility of the note issue into gold and troubled not in the least over similar backing for the deposits. It must be remembered, however, that at that time the note issue of the Bank was over twice as large as its deposits; to-day, taking all the great banks as well into consideration, the deposits are many times as large as the note issue. It was nevertheless a lack of imagination which did not occur in other countries when they later established their central bank systems. As it happens, however, the wisdom of, and the skill exercised by, the Bank, as well as the unexcitable mentality of the British public, fortunately made the blunder one of little moment, although it might constantly have been a source of danger.

The Ratio

It was mentioned early in this chapter that the ratio of the gold held to notes in circulation was the factor which decided whether further accommodation could be granted or otherwise. If the ratio were running low it would have to be refused. Gradually, as deposit banking grew and it became obvious that a liability to an account holder was not in the least degree different from that to a note holder, the gold came to be considered in relation to the two liabilities jointly, as is witnessed by the Bank's pre-1844 practice of holding gold as one-third of its assets. Since liabilities are equal to assets and the former include the Capital and Rest, it is obvious that more than one-third of the liabilities of the Bank to the public by way of notes and deposits was maintained in gold under this rule. After the Act, the tendency gradually developed to regard the Issue as taking care of itself, by reason of the segregation of the Department, and it became the practice of the Bank and the market only to concern themselves with the question of the ratio of the notes and coin in the Banking Department to the public and other deposits. It will

be realised that the notes held were actually the equivalent of gold, for the Banking Department had only to present them to the Issue Department in order actually to obtain gold.

Thus it was that whenever a position arose involving a drain of gold abroad the circumstance was reflected in a fall alike in 'other deposits' and in the Banking Department's notes and gold. If the drain persisted, steps were taken to attract remittances from abroad, which generally resulted in gold flowing inwards, so restoring the position; the nature of these steps will be seen later. If however matters went from bad to worse, and the public grew nervous, its preference for notes instead of a credit balance accentuated the depletion of the 'Reserve,' as the notes and gold in the Banking Department came to be called. It was whenever such serious circumstances as these arose that the Bank would decide to approach the Government and ask for the suspension of the Bank Act (1844); that is to say, they applied for permission to exceed temporarily the limit of the fiduciary issue. This happened in the crises of 1847, 1857, 1866, and 1890. The news that additional money would be forthcoming, if required, always instantly soothed the apprehensive ones and the crisis was soon over.

The Bank's Prestige

Since the passing of the Bank Act no further friction between the Government and the Bank has ever occurred. The constantly increasing prestige and importance of the premier institution set up a tradition of stability and unassailability; so much so that, during the second half of the nineteenth century and the early years of the twentieth, any criticism or disapproval of its actions was almost regarded as on a par with adverse comment upon the Throne of those Victorian and Edwardian days. And the Bank carried on from strength to strength, with ever-increasing pontifical hauteur and magnificent aloof-

ness from the more plebeian joint stock banks, as well as from the manufacturing and mercantile community.

The increasing importance of Britain in the world commercial sphere had as a natural corollary the increasing magnitude of its financial interests and, as the centre of our domestic and overseas banking organisation, the Bank steadily grew in international reputation. The effect of the 1844 Act had been to confer upon the Bank of England the sole guardianship of the ultimate gold reserves of the country, and it gradually withdrew from the competitive hurly-burly of commercial banking. This was made the easier by the fact that it had become the bankers' Bank in addition to its duties as agent to the Government, which involved an enormous and ever-increasing volume of business.

As the principal Gold Standard country, Great Britain had peculiar responsibilities, and the control of the working of the standard here, in so far as it was not automatic, was entirely the task of the Bank of England; under the Act, it had the duty to protect the gold reserves from undue denudation; but international comity imposed upon it the necessity of preventing also an undue excess of gold.

Occasional ripples on the surface of the ocean of British finance were at times stirred up into something like waves on the few occasions of threatened crises, minor wars, and political disturbances, but not even the South African War, coming on top of a grave and prolonged trade depression, was able to raise a tempest sufficient to cause serious anxiety for the safety and welfare of the Bank of England and the banking system in general.

The Great European War

And so matters proceeded in a comparatively gently oscillatory manner until the outbreak of the Great War in 1914. Suddenly all landmarks of finance were overwhelmed and a new era started. At the outset,

the enormous obligations of the London banks and Acceptance Houses made on behalf of customers who had become enemy debtors, and therefore useless from the point of view of recourse, had to be financed by the Bank of England under guarantees instantly given by the Government in order to avoid chaos. A patriotic appeal for gold to be surrendered in exchange for paper brought in enormous sums in sovereigns and half-sovereigns which had been in circulation as money. The colossal speed-up in industrial production for war purposes created money on a scale previously unheard of, and thus necessitated more and more currency, far in excess of the amount permissible under the Bank Act, even after considering the large amounts in gold brought in by the public as a result of the appeal. This was provided by an entirely new note-issuing authority, the Treasury, which, in the early days of the conflict, was authorised to issue 'Treasury Notes,' thus altering almost overnight the monetary policy of over two centuries. Great Britain in common with all belligerent countries abandoned the Gold Standard and, as had occurred during the Napoleonic wars, the currency became inconvertible into gold.

The Gold Standard

It has previously been mentioned that under the 1844 Act any person could take gold to the Bank of England and demand notes at the rate of £3, 17s. 9d. per ounce of standard gold eleven-twelfths fine (*i.e.* $\frac{11}{12}$ pure gold and $\frac{1}{12}$ alloy, which, after an adjustment of $1\frac{1}{2}$ d., is the equivalent of £4, 5s. per oz. of fine gold). Conversely he could present notes and demand in exchange the equivalent in gold, these rights being inherent in the Gold Standard, of which we shall read much more hereafter. Upon the outbreak of the Great European War the Gold Standard was suspended and the obligation to hand out gold abrogated. The holdings of the Bank continued to be valued at 85s. although gold

actually became more valuable upon the market. Only in 1925 did it become possible, as the result of much striving, to bring down the value of gold, or rather to bring up the value of our currency until the paper price of gold was again 85s. per fine ounce, and thus render possible a reversion to the Gold Standard. There was a difference as compared with pre-1914 in that the gold coinage was not resuscitated nor was it technically so easy actually to withdraw gold from the Bank; however, a Gold Standard was in being, and remained so for six years.

It will be within the recollection of most that in 1931 grave disquiet as to the state of British finances was experienced abroad, and as many foreign countries were holding sterling, in the belief that it was the equivalent of gold, this disquiet suddenly gave rise to phenomenal withdrawals of the metal. Attempts were made to stem the outflowing tide by borrowings from France and the U.S.A., but all in vain. After losing some £200 millions, including the credits from the countries mentioned, the Government was forced again to suspend the Gold Standard by revocation of the 1925 Act. Since that time we have been 'off gold,' and according to the general consensus of opinion it seems unlikely that we shall ever go back to it in the former sense.

It was thought advisable in 1928 to have all the note issues once more concentrated in the hands of the Bank of England. The latter was therefore authorised by the Act of that year to issue £1 and 10s. notes, and the liability for an issue of some £360 millions worth of Treasury notes, together with the relative cover, was transferred from the Treasury to the Bank with almost magical ease and smoothness, the notes being gradually replaced by those of the Bank of England. The Bank Return of 28th November 1928, the first one to appear after completion of the operation, is shown below; it is interesting to compare its figures with those of the Lilliputian accounts of 1844.

ISSUE DEPARTMENT

Notes Issued		Government Debt .	£11,015,100
In Circulation .	£367,001,148	Other Government	
In Banking De-		Securities .	233,568,550
partment .	52,087,797	Other Securities	10,176,193
		Silver Coin .	5,240,157
			<hr/>
		Amount of Fiduciary	
		Issue .	260,000,000
		Gold Coin and	
		Bullion .	159,088,945
			<hr/>
	<hr/>		<hr/>
	£419,088,945		£419,088,945

BANKING DEPARTMENT

Proprietors' Capital . .	£14,553,000	Government Securities . .	£52,180,327
Rest	3,254,001		
Public Deposits * . .	21,452,051	Other Securities .	
Other Deposits:		Discounts and Advances	
Bankers	£62,379,409	£13,586,293	
Other A/cs.	37,185,203	Securities	20,214,855
			<hr/>
	99,564,612	Notes	33,801,148
Seven-day and other Bills .	2,649	Gold and Silver Coin . . .	52,087,797
			757,041
	<hr/>		<hr/>
	£138,826,313		£138,826,313

* (Including Exchequer, Savings Banks, Commissioners of the National Debt, and Dividend Accounts.)

C. P. MAHON (*Chief Cashier*).

Dated the 28th day of November 1928.

It is unnecessary to comment upon the Return other than in respect of two points. The first is that, in accordance with the Cunliffe Committee's recommendation, the figures of several headings are divided into two sections, the additional information so disclosed being very useful to the Money Market. The other concerns the fiduciary issue. The limit for currency notes was fixed for 1928 at a figure just short of £245 millions. Added to the Bank's own fiduciary limit of £19,750,000 (at which figure it stood in 1923) this made a total of over £264 millions. An adjustment in respect of the pending withdrawal of notes from Ireland brought the limit down to about £260 millions, at which round figure it was fixed. Power was given to the Treasury, however, to vary this at will, and it successively stood at £230,

£400, and £300 millions between 1st January 1939 and May 1939. These remarkable fluctuations were due to interactions between the Bank and a new factor in the market, the Exchange Equalisation Account. This latter is a department of the Treasury which was set up to protect sterling from violent fluctuations in terms of other currencies as manifested by the foreign exchange rates. In pursuance of its operations it acquires gold on a large scale from time to time, and on one occasion it sold gold to the Bank in exchange for securities. Since the Bank under the unrepealed Acts was only permitted to purchase gold at 85s. per fine ounce, the book loss on the transfer was temporarily borne by the Account. It was on this occasion that the fiduciary issue was reduced to £230 millions. In January 1939 the Account had parted with large amounts of gold in the course of its duties and it was necessary to take back from the Issue Department the gold formerly transferred. Then it was that the fiduciary issue was increased to £400 millions. However we shall learn more of the Exchange Equalisation Account in later chapters.

The Gold Revaluation

After the departure from the Gold Standard in 1931 the value of gold gradually appreciated, until it reached the figure of nearly 150s. at the end of 1938. It was obviously an anachronism that gold of such value should continue to be shown in the Bank Return on a basis of only 85s. After the transaction between the Issue Department and the Exchange Equalisation Account in January 1939, mentioned above, the authorities decided to revalue the gold in the Bank in accordance with the current market price. In the Return for 2nd March 1939 are seen for the first time the results of that decision reflected in the figures, the gold having been valued at 148s. 5d. instead of at 85s. as in the previous week's Return. The profit on that revaluation belongs to the Government, and equally any profit upon further en-

hancement of the gold value or any loss upon a fall will be for its account through the Exchange Equalisation Fund.

ISSUE DEPARTMENT

Notes Issued . . .		Government Debt . . .	£11,015,100
In Circulation . . .	£478,448,520	Other Government Securities . . .	288,386,625
In Banking Department . . .	47,965,955	Other Securities . . .	12,083
		Silver Coin . . .	586,192
			<hr/>
		Amount of Fiduciary Issue . . .	300,000,000
		Gold Coin and Bullion (at 148s. 5s. per oz. fine)	226,414,475
			<hr/>
	<hr/>		<hr/>
	£526,414,475		£526,414,475

BANKING DEPARTMENT

Proprietors' Capital . . .	£14,553,000	Government Securities . . .	£99,046,164
Rest . . .	3,654,252	Other Securities . . .	
Public Deposits (including details as before) . . .	11,643,224	Discounts and Advances . . .	£6,349,490
		Securities . . .	22,398,292
			<hr/>
Other Deposits: Bankers . . .	£110,361,073	Notes . . .	47,965,955
Other A/cs. . .	36,549,537	Gold and Silver Coin . . .	1,001,185
	<hr/>		<hr/>
	£176,761,086		£176,761,086

K. O. PEPPIATT (*Chief Cashier*).

Dated the 2nd day of March 1939.

Thus has the Act of 1844 gone almost completely by the board, and it only remains for the agitation against the segregation of the Issue Department to grow in strength—there are strong opinions in favour of it—for the Act which has governed the note issue for a century to become merely an archaic memory.

The historical side has been discussed fully for the reason that the history of the Bank of England is largely that of financial England, demonstrating how political conditions so largely governed the monetary policies alike of the State and the Bank.

The Bankers' Bank

It is desirable now to discuss briefly the position which the Bank occupies in modern times. Apart from its note-issuing capacity, the functions it fulfils are twofold. First it operates as an ordinary banking concern and secondly as the Central Bank of Great Britain. Partly owing to its early monopoly, and thereafter to its ever-increasing prestige, it gradually became the focal point of the London Money Market and, later, the bankers' Bank. The working of the Bankers' Clearing House made it necessary for all participants to maintain an account at the Bank; the other important monetary institutions, such as the private and merchant bankers, as well as the great discount houses, found it advantageous to do likewise. Imperceptibly the Bank became the mentor and paternal guardian of the whole system of British finance. In times of speculative activity it would drop a hint here, or a more positive suggestion there, that the particular institution in question would do well to 'shorten sail' in view of the impending financial 'stormy weather.' And the hints have been given when the skies were apparently cloudless, for the Bank is generally in a position to know when the commitments of a concern are becoming top-heavy or unwieldy; if the need arose it backed its views with more direct advice, and perhaps admonitory action which no institution could afford to ignore.

The Baring Crisis

If a house found itself in actual difficulties its partners or directors repaired to the parlour of the Bank, placed the situation before the Governor and asked for support. Many instances are on record where the safety of the City was threatened by an impending disaster and the situation was restored to normal by the timely aid given by the Bank, either alone or in conjunction with the other financial institutions. The classical example is

that which occurred during the Baring crisis in 1890. The name of this powerful firm of private bankers, world-famous as an issue house for loans required by foreign governments, stood as the synonym of wealth. The phrase 'as rich as a Baring' had come to supplant the reference to Cræsus in the same connection; Gilbert in *Iolanthe* absurdly rhymed:

'The shares are a penny and ever so many
Are taken by Rothschild and Baring.'

Whispers had begun to be heard as to the position of this firm, which had in fact made unwise commitments in the Argentine and elsewhere and was in imminent danger of collapse. The Bank appointed a committee to examine the position, which found that, although 'locked up,' the firm was solvent. A huge loan was immediately granted, the financial interests in the City joining in by providing a guarantee fund of £10 millions to indemnify the Bank against loss, and the crisis was over before the general public even heard of the danger.

The Central Bank Function

The ordinary banking business of the Bank is one which is carried on with the normal object of making a profit for its shareholders, but this has greatly decreased in importance so far as the ordinary commercial customers are concerned; these are now left to the other banks. But its business as Bankers to the Government of course grows every year in volume and importance. It is from its position, however, as the bankers' Bank that it derives the power to carry out its second and all-important function, that of a Central Bank. Since the banks keep their reserves of cash, apart from till money, with the Bank of England, and as their creations of credit, *i.e.* bank money, are bound up with the volume of their cash reserves, it follows that if the Central Bank is able to influence the volume of such reserves it controls the ultimate issue of credit. We

shall see in a later chapter how a Central Bank can, and in fact does, control credit through the exercise of this power.

The Bank of England in carrying out its function as the Central Bank performs duties which, from a profit-earning point of view, can, and often do, conflict with the interest of its shareholders. It is greatly to the Bank's credit that, throughout its history, public duty has been the paramount consideration in governing its conduct. It is due to this fact that such an anomalous institution has been able to retain its private character and ownership, as well as freedom to elect its own Governor and directors without interference by the State, which has not even required representation on the Board. It is true that in the early days of its history an occasional conflict of views arose between the Government and the Court of Directors; Peel had to use the threat that the Charter would not be renewed unless the Bank surrendered some of its privileges which, he felt, were tending to make it somewhat independent and monopolistic in character. But no suggestion was ever made that the Bank let profit considerations rule its policy if the public welfare demanded a contrary course. And since Peel's time the Bank has invariably worked in the closest harmony with the Treasury, in what both have believed to be the best interests of the country. The Bank of England has a magnificent tradition behind it, and, despite occasional policies subsequently found to be mistaken, its record commands the respect and confidence not only of Great Britain but of the entire world.

Chapter IV

THE ENGLISH AND SCOTTISH BANKING SYSTEM

THE Act of 1826 was the starting-point of the system of joint stock banking in England. As we have seen, prior to that date any banking organisation of more than six members or partners was illegal. The authority conferred by the Act to institute more powerful concerns outside the radius of sixty-five miles from London was immediately utilised and five joint stock banks were founded in Lancashire and Yorkshire, not all of which availed themselves of the privilege which the Act accorded of issuing their own notes. Within five years this number had increased to some fourteen banks and by 1833 there were about thirty.

The right to establish similar banks in London was not definitely conceded until the Act of 1833 expressly authorised their foundation, but the right of note issue within the sixty-five-mile radius remained prohibited. The important and almost immediate result of the Act was the formation of the London and Westminster Bank, followed within a year or two by the London Joint Stock Bank, the Union Bank of London, and the London and County Bank.

Early Difficulties of the Banks

The early history of the joint stock banks was a chequered one. The hostility of the Bank of England as well as that of the private banks made progress difficult, and in London particularly the opposition was both active and vindictive. For example, the Bank of England refused at first to open an account for the London and Westminster Bank and later consented only after quoting quite prohibitive terms. Again, it refused to discount bills which were accepted payable at the

new joint stock banks, even though the names on the paper were first-class. The private banks for their part refused them admittance to the London Clearing House. Another early hindrance was that in any action, however trivial, the names of every shareholder had to be quoted as plaintiffs or defendants, as the case might be, for the bank could not sue or be sued in its own name nor in the names of representatives; a subsequent Act, however, removed the legal anomalies and stupidities. Fortunately for them, these London banks possessed able and energetic management which fought back and won through the manifold difficulties impeding them.

The Question of Shareholders' Liability

The development of the joint stock banks both in London and in the country was slow. For one reason, the fact that the liability was unlimited did not encourage prudent investors to embark upon enterprises which they could not personally supervise. In the country several concerns which failed through ignorant or fraudulent management involved their unfortunate shareholders in complete ruin. In such cases the weaker members were quickly reduced to bankruptcy, leaving the wealthier ones to shoulder the heavy losses to the last farthing. As a result of one of these disasters it was decided to extend the principle of limited liability of shareholders to the joint stock banks, and in 1858 an Act was passed authorising this. Curiously enough, few banks availed themselves of the privilege to commence with, fearing that their depositors might think their security weakened and take fright. Some twenty years later, however, after the appalling crash of the City of Glasgow Bank (in which residuary shareholders were called upon to pay £2750 in respect of each £100 of their holdings), new legislation was enacted with the result that most of the large concerns adopted the limited liability principle.

The inexperience of the directors of the country banks

on more than one occasion led to over-issues of paper or credit which undoubtedly caused crises, with resultant 'runs' first upon their own institutions and then upon the Bank of England, causing serious loss to the gold reserves. There can be little doubt that the long suspension of cash payments which started in 1837 was largely due to the country banks.

The Migration to London

Notwithstanding these early struggles many of the country concerns pulled through, and the growing experience of the management built up a body of strong local banks which survived right up to the twentieth century. Some of these migrated to the capital, either by absorption of London private banks or by opening their own offices there, and became exceedingly powerful institutions. Examples of these are Lloyds Bank Limited and the Midland Bank Limited, both of which originated in Birmingham, Barclays Bank Limited, which came from the Eastern Counties, and the National Provincial Bank Limited, which started in Gloucester. The motive underlying these migrations was to acquire a footing in London, where the large financial opportunities were to be found.

Issue versus Deposit Banking

It has been shown how strong was the belief that the privilege of note issue was the most important factor in banking and how the Bank of England strove to keep the monopoly in this class of business. Its success in preventing other issues within the sixty-five-mile radius of London drove the joint stock banks to develop the deposit business, where customers made payments by cheques or orders upon them. It soon became apparent that herein lay a method greatly superior in convenience, for customers were thereby saved the trouble and risk of carrying around notes and coin to the offices of their creditors whenever a debt had

to be settled. Moreover the cheque could be drawn for the precise amount of the account and provided a record of the transaction. When the creditor was situated in another town the convenience was even more pronounced.

Moreover it was soon discovered that it mattered not at all whether a loan was taken by the customer in the notes of the bank or whether the amount was placed to his credit in a drawing account from which he drew it by cheque; both methods were equally profitable, particularly as the banks found that it was not now necessary to allow interest on drawing accounts in order to retain the business. Consequently the London banks were the less concerned to continue their antagonism with their rival, whilst the country banks quite readily surrendered their note-issue privileges in order to open in London, and to gain seats in the Clearing House. The private bankers had by then realised the folly of excluding the joint stock banks from the Clearing House since the only result was to make additional work for themselves.

Bank Amalgamation

The development of British banking has consistently been along the lines of amalgamation and absorption. The number of separate institutions has steadily diminished, but these have grown into enormous concerns, each with a network of branches all over the country. The policy has been carefully thought out, for fusions have usually taken place between concerns complementary in character. A London bank with branches in the Home Counties and agricultural districts, for instance, would take over another concern which operated mainly in industrial areas, and vice versa. The process steadily continued, until to-day there are scarcely more than nine separate joint stock banking institutions in England, if the Scottish banks in London, the foreign and colonial banks, and the merchant-bankers

are left out of the reckoning. Thus the big five, as Barclays, Lloyds, the Midland, National Provincial, and Westminster banks are popularly called, control the bulk of the banking business and direct it from London. The only banks still to resist this tendency and which retain their independence to-day are the Lancashire institutions. Several attempts have been made by the Metropolitan goliaths to swallow them but local feeling has always been too strong to allow the fusions to take place. The District Bank in Manchester thus retains its own identity and complete freedom from London control. The Bank of Liverpool Ltd., which turned the tables on London by absorbing Martins Bank, is directed and managed from the northern seaport, although it ultimately dropped its regional cognomen and adopted that of its south-country acquisition. The Union Bank of Manchester up to recent times still retained its own board and separate identity in cottonopolis although its shares had been acquired by Barclays Bank Ltd. Consequently its ultimate policy was always under the control of its London owners and now the bank has actually been absorbed by Barclays. The Williams Deacons Bank Ltd. of Manchester has been acquired through the purchase of its shares by the Royal Bank of Scotland, which thus avenged the blow to Scottish pride suffered when most of their other banks came under the domination of the English big five. All these indigenous banks of the north country have large chains of branches. In the summer of 1939 the Royal Bank of Scotland sprang another surprise on the financial world when it announced that the largest private bank, Glyn Mills & Co., had been acquired. The latter still functions, however, under its old style.

There seems little room to doubt that the process of large-scale amalgamation has now come to an end. When Lloyds Bank Limited in 1918 absorbed the very considerable Capital & Counties Bank Ltd., following upon a series of important absorptions by other of the

London banks, the mercantile and industrial community became uneasy, fearing that if the movement continued the big five might in time amalgamate with each other and so achieve an absolute monopoly in money and banking, whilst the customers' interests would suffer from the absence of any effective competition. The Government set up a committee which recommended legislation making it impossible for any further amalgamations to take place without the consent of the Treasury; this was to be refused if the proposed fusion resulted in any considerable overlapping of branches or if the resultant enlarged deposits of the new concern were unaccompanied by correspondingly increased capital and reserves. In other words, there must be good reasons for amalgamation other than mere competition in size, and the capital resources must be commensurate with the liabilities of the new organisation. The legislation was never actually enacted, but in practice any contemplated arrangements have since been submitted to the Treasury, which is usually exceedingly reluctant to give consent unless adequate public advantages are likely to accrue from the fusion. Since 1918 a number of amalgamations have in fact taken place, but only by way of absorption of the smaller local banks. The Treasury acquiesced in these operations, but it certainly would have negatived proposals involving a marriage of any two or more of the very large national institutions.

Centralisation of Control

There is a prevalent belief that the concentration of banking into a few powerful hands in London is detrimental to the interests of provincial borrowers. To a certain extent this is justified, since local private bankers in the old days were often willing to make loans to firms or individuals on the strength of their knowledge of the character and ability of these entrepreneurs, who often were not in a position to deposit security of the easily

realisable nature demanded by London controllers of bank advances. It is only fair to say, however, that agriculturists farming their own land are generally able to obtain accommodation against little more than a verbal promise to liquidate the advances out of the ultimate proceeds of their growing crops, and people of substance are often assisted against quite intangible security.

Another belief is that the provinces are starved of loans in the interests of the large international borrowers in London. This is an entirely erroneous conception of the facts, since it is based upon the assumption that there is only a limited fund to be divided amongst claimants. It will be shown later that this is quite untrue and that there need be no limit to advances provided that they are utilised to assist production and a higher national standard of living.

Despite opinions, erroneous or otherwise, that amalgamations are detrimental to country interests, there are powerful reasons why this development has been on the whole beneficial. The main advantage derived is that of stability. In the days of small local or regional banks the fortunes of the institutions varied with those of the local industries. If these trades flourished, well and good, but if they declined, the bank, usually lent up to the hilt in them, became embarrassed at once, and if it failed spread even wider the circle of disaster.

A series of crises occurred with monotonous regularity through the nineteenth century in the course of which banks failed, causing distress and hardship in the districts affected as well as sympathetic disturbances over larger areas, often spreading to London. Since the Baring crisis in 1890, despite the enormous stresses set up by the two Great Wars, by the post-European War inflation, or by the deflation culminating in the re-abandonment of the Gold Standard in 1931 (see Chapter IX), as well as by many other causes only

slightly less serious in effect, no major difficulties have been experienced in the banking system. Public confidence is so deeply rooted in the manifest strength of the enormous concerns, as well as in belief in the prudence and honesty of the management, that it seems well-nigh impossible that any recurrence of financial hysteria will take place such as was the immediate cause of the nineteenth-century failures.

It is instructive to examine the figures presented by the large joint stock banks. If we amalgamate the balance sheets of the eleven London clearing banks the size and strength of the system becomes readily apparent. These banks consist of the big five, Martins, District, Williams Deacons, Glyn Mills & Co., Coutts & Co., and the National Bank. The last-named of course operates largely in Ireland as well as in England, and it is impossible for the figures applicable to the two countries to be separated. It does not matter greatly, however, since in total they are barely $1\frac{1}{2}$ per cent. of the whole. This list practically comprises the whole of the English banking system concerned with ordinary domestic business. The colonial and foreign banks of course do handle some part of it in the course of their activities, but the proportion is very small. Here then is the combined balance sheet of the eleven concerns mentioned as on the 31st December 1938, a convenient date before the Great World War began to derange the normal course of banking business (see opposite).

The figures given in this composite balance sheet are grouped under the essential headings. In the individual balance sheets they are generally, though not invariably, given in somewhat greater detail. It was one of the complaints of the Macmillan Committee of 1931 that the banks were unduly secretive in their statements of account, particularly as to the composition of their assets, and certain germane recommendations were made in their report. Some banks have followed these recommendations more or less faithfully; one of

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COMBINED BALANCE SHEET OF ELEVEN MEMBER BANKS OF THE LONDON CLEARING HOUSE AS AT 31ST DECEMBER 1938

<i>Liabilities</i> (Credit balances owed to customers and others)		<i>Assets</i> (Debit balances owed by customers and others)	
Capital paid up . . .	£78,198,133	Cash in hand and with the Bank of England . . .	£254,969,793
Reserve Fund	60,587,194	Cash with, and Cheques in Course of collection on, other British Banks . .	86,116,667
Current, Deposit, and other Accounts	2,264,550,026	Money at Call and Short Notice	154,138,804
	£2,403,335,353	Balances with Banks	2,801,870
Balance of Profit and Loss Account	7,809,774	Abroad	233,080,396
Acceptances, Endorsements, Guarantees, and other Obligations	128,859,527	Bills discounted	627,418,632
		Investments	24,196,767
		Investments in Affiliated Banks	984,466,553
		Advances to Customers . .	43,955,645
		Bank Premises	
		Liability of Customers for Acceptances, Endorsements, Guarantees, and other Obligations (as per contra)	128,859,527
	<u>£2,540,004,654</u>		<u>£2,540,004,654</u>

the big five, for instance, produces a balance sheet which is comparatively full of information, and it is a pity that all the banks have not thought fit to agree upon a standardised form based upon the lines suggested in the report.

Capital

The capital of the banks which has been paid up stands at the imposing figure of £78·2 millions. The subscribed capital of the nine joint stock banks is no less than £252·5 millions, which is a factor of great strength and assurance to depositors, for were unimaginable disaster to befall, and the assets to lose much of their value, the shareholders could be called upon to subscribe the uncalled capital for the benefit of the creditors of the concern. As to the two private banks, their partners or owners have subscribed £2,060,000, and as their liability is unlimited they would be responsible to the utmost extent of their fortunes for any deficit arising in the circumstances mentioned above.

The practice of banks varies greatly in regard to capital. Barclays Bank, for instance, has a small subscribed capital which is fully paid up, whilst Lloyds has a large subscribed capital, a small part of which, the 'B' shares, is fully paid up, whilst the bulk is in 'A' shares of £5 nominal value, of which only £1 has been paid up.

As matters stand to-day a joint stock bank may be in any one of three categories as regards capital position. Its shares may be fully paid up, partly paid up, or partly paid up with an addition of a declared 'Reserve Liability.' The balance-sheet figures of banks respectively in these three categories might read as follows:

(A) Authorised Capital in 1,000,000 shares of	
£5 each	£5,000,000
Issued and fully paid up	£5,000,000
(B) Authorised Capital	
	£5,000,000
Issued 1,000,000 shares of £5 each, £1 per	
share paid up	£1,000,000
(C) Authorised Capital	
	£5,000,000
Issued Capital 1,000,000 shares of £5 each	£5,000,000
Callable Capital of £1 per share	£1,000,000
Reserve Liability of £3 per share	£3,000,000
Paid-up Capital of £1 per share	£1,000,000

In the case of (A), a person examining the balance sheet would understand that the shareholders have no further liability under any circumstances whatever, whilst in (B) shareholders have only paid £1 on their shares and the directors can call upon them to pay further amounts up to £4 per share if they wish to develop the business or, in the case of a winding-up, to the maximum extent of the still uncalled amount in order to make good any deficit to the creditors. In the case of (C) the directors can call up only a further £1 per share for development purposes whilst the Reserve Liability of £3 is available only in the event of a bad

winding-up necessitating the making good of losses to creditors.

The Reserve Fund

The Reserve Fund of £60.6 millions is another item making for strength. It represents, of course, profits which have not been distributed to the shareholders but have been set aside to meet emergencies. It is of interest to mention that during the slump following the year 1931, when the values of securities fell disastrously, several of the great banks had recourse to their reserves in order to write down their huge holdings of securities to the current market values. Since then they have gradually restored their funds out of the profits made upon sales of these securities after the recovery in prices had taken place.

In connection with the Reserve Funds, it may be mentioned here that when criticism of the high rate of profits earned by the banks becomes more vocal than usual the reply invariably, and not unjustly, points out that the figure of the capital must be increased by that of the reserve before the percentage is calculated, for the reserve is in reality nothing more than additional capital which has been left in the business by the shareholders out of their past earnings. Thus, for instance, the Midland Bank Ltd., which pays 16 per cent. dividend reckoned on £15 millions of capital, would rightly claim that the Reserve Fund and balance of Profit and Loss Account provide a further £14 millions, so that the capital is really £29 millions and the true yield only 8.3 per cent.

It is a well-established fact that the banks have hidden reserves in addition to those published in their balance sheets. These secret funds are used to meet bad debts, which, despite all precaution, will occur in the best regulated banks. It is possible that they also act as reservoirs into which excess profits are run during good times and taken out during lean periods, thus

tending to equalise the earnings as published in the annual Profit and Loss Accounts. The balances of these secret reserve accounts are included with 'current deposit and other accounts,' which heading is the next item on our balance sheet.

Current Deposit and Other Accounts

For no very apparent reason, the banks in general decline to differentiate in their individual balance sheets between 'current accounts' and 'deposits,' but fortunately they give the details to the Bank of England, which publishes the combined average figures in its monthly statistical survey. It is perhaps unnecessary to explain that current accounts are those upon which the holders may issue cheques at will, whilst deposit accounts are those which can only be drawn upon after notice has been given to the bank, whether at the usual fourteen days', one or more months up to twelve, or upon the expiry of a fixed period which has mutually been agreed upon. No interest is usually given upon current accounts in London although in some provincial regions a small allowance is made. On the other hand, interest is allowed in London on deposits at a published rate, called the short-deposit rate, for money at seven days' notice and at somewhat better rates, which generally are subject to negotiation, for longer period money. In the country the deposit rate is usually higher than in London, at one time being $2\frac{1}{2}$ per cent. fixed, although during recent years in most cases it has been reduced to $1\frac{1}{2}$ per cent. or even less. The short-deposit rate is anchored to the Bank Rate and in normal times in London is 2 per cent. below it. When, however, the Bank Rate itself was reduced to 2 per cent. the short-deposit rate was fixed at $\frac{1}{2}$ per cent.

There is another class of accounts included in the figures under this heading, the Savings Bank Accounts. Some time after the Great European War of 1914 there commenced between the big five a competitive frenzy

to increase their deposits, which was perhaps not unconnected with the advertisement value of being the largest bank, since size is measured by the deposit figure in the balance sheet. Interest at the fixed rate of $2\frac{1}{2}$ per cent. was the same as that allowed by the Post Office and the local Savings Bank associations. Whilst this rate was not unduly onerous to the banks in times of high Bank Rate, the additional attractions offered by the big five were sometimes undignified and the final results cannot have been very remunerative. During the years of exceptionally cheap money (*i.e.* at low interest rates), when the Bank Rate itself was only 2 per cent., the accounts cannot have been regarded as other than an unmitigated nuisance, except in so far as they made the holders bank-conscious and led to the opening of current accounts. They must certainly have been considered a very expensive form of propaganda and the banks are probably heartily sorry that they ever embarked upon their earlier campaign, the more so as it was not particularly effective as a deposit-increasing scheme since bank money usually stays within the system in any event.

The Bank Rate

It is appropriate here perhaps to explain the term Bank Rate for, as everyone knows, it is the pivot upon which all interest rates are apt to revolve. Theoretically the Bank Rate is that at which the Bank of England is prepared to discount approved bills of exchange for its customers and the money market. In practice, however, the Bank would nowadays discount bills for its customers in the ordinary course of business at the 'market rate'; this is the rate at which the ordinary banks would discount bills and is considerably lower than 'Bank Rate.' Should, however, the market in times of monetary pressure, such as often occurs in June and December, be driven to the Bank for accommodation which they are unable to obtain elsewhere,

they would have to pay the higher rate. More will be said of the money market later in this chapter when we come to examine the assets side of the balance sheet.

The Bank Rate was in former days a very potent instrument in the working of the Gold Standard, and the weekly Return of the Bank was always anxiously examined by the market in order to decide whether any change in the Bank Rate was likely to occur—a matter of moment to those dealing in millions upon very small margins. Nowadays the Bank Rate is of smaller importance in the world of monetary economics, but in principle it still governs the rates charged or allowed to customers by the banks on advances and deposits respectively.

To return to our balance sheet, the proportion between the aggregate of current accounts and that of deposits has been utilised by some economists as an indication of the probable movement of price-levels, but the attempt has not been very successful. Roughly speaking, the greater the aggregate of current accounts or immediate purchasing power, the more is spending likely to take place, but there are so many cross-currents in operation that the indications are very unreliable. More of this, however, will be seen when the Quantity theory and the phenomenon of 'velocity' of money are tackled. In considering the figures of current, deposit, and other accounts it is perhaps necessary to mention that they are the total of all the credit balances of customers and not the net figure after a deduction of overdrafts standing to the debit of the same or other customers.

Profit and Loss Account

The next item on the liabilities side of the balance sheet is the Profit and Loss Account. The figure of 7·8 millions is high, but that is natural on 31st December, for the final dividends will not be paid until after the

annual general meetings early in the new year. The account therefore is full of the year's profit less the interim dividends which have been disbursed shortly after the beginning of July. By the time the final dividend disbursements have been taken out the account will have fallen to £3,528,350, which is about the usual amount of the carry-forward. During the year 1938 the declared profit of the nine joint stock banks (the two private banks Glyn's and Coutts do not publish profit and loss accounts) was £11,305,675, of which £8,423,691 was distributed in dividends; this shows an average return on paid-up capital of 15.2 per cent. before deduction of income tax. Calculated on capital plus reserves the figure is 8.6 per cent. gross, not an extravagant return by any means. The difference between the profit and the distribution has almost entirely been utilised to write down the book value of the bank premises and to strengthen the published and hidden reserves, or contingency accounts as the latter are usually called.

Cash in Hand and at the Bank of England

Leaving for the moment the last item on the liabilities side of the balance sheet, let us turn to the assets side, which of course represents funds owing to the banks and the value of their properties and securities. The first and foremost item is that of 'cash in hand and with the Bank of England.' By an unwritten law the banks keep a minimum of 10 per cent. of their 'current deposit and other accounts' either in notes and coin in their tills or in their accounts with the Bank of England. There is nothing sacrosanct in this proportion, but experience has shown that it is ample for extraordinary demands and much more than ample for the ordinary day-to-day cash requirements of customers. Hence the custom has now the sanction of general consent. Needless to say, the item is entirely an unproductive one from a profit-earning point of view. It will be

observed that with the handsome figure of £254.9 millions the percentage on this occasion was 11.2, an exceptionally strong position.

Cheques for Collection

The next line of defence in the security of the banks is the item 'Cash with, and Cheques in course of collection on, other British Banks.' It will be realised that the banks keep mutual accounts with one another for convenience in adjusting transactions which are not applicable to the clearing house. For instance, if a customer of Barclays wishes to pay in funds at a town in which Barclays has no branch he may pay in, say, at the Midland branch, and the latter bank will give Barclays credit in an account pending settlement. Such an item outstanding on 31st December would be reflected in the 'Cash at other banks' in Barclays' balance sheet. But by far the greatest proportion of the item is represented by cheques in course of collection. These are the cheques paid in during the last few days of the year by customers all over the country, most of which are in transit to London from the provinces to be cleared through the Bankers' Clearing House. Since such cheques cannot be cleared in less than three working days it is easy to imagine that considerable sums will thus be in transit on any given day. Similarly, cheques paid in to their credit by customers at branches in the metropolitan area cannot be cleared in less than two working days. Finally, large figures may be uncleared at the Town area offices in London in respect of cheques missing the final 'Town' clearing as well as cheques on non-clearing banks and warrants upon Government departments. Since all these cheques, except an infinitesimal proportion of irregular or bad items, will be paid within three days at the outside, they are almost as good as cash, and are so regarded as next to actual cash in order of liquidity. The vast bulk of the £86.1 millions may be regarded as

consisting of uncleared cheques, since the balances left with other banks will be very small over the year-end.

Market Money

The third item, 'Money at Call and Short Notice,' requires a somewhat more detailed explanation, as the funds so described are lent to that remarkable, and to many people slightly mysterious, entity known as the London Money Market. This principally consists of a group of financial concerns known as the Discount Houses, whose function is to buy and sell bills of exchange. In the earlier days of the London Market, as has already been mentioned, finance was mainly carried on by bills, and these Houses, as well as the smaller bill brokers, performed a very vital service in purchasing them at first-hand from traders, since their highly specialised knowledge of the parties to the bills enabled them to discriminate between first-class trade paper and that of lesser standing. Again they made the London finance market available to the provinces by re-discounting bills which had been bought by the country banks from the smaller local traders. It was impossible for the Discount Houses to purchase the large volume of bills constantly coming on to the market, even with their own large resources, and these concerns therefore borrowed from the London banks, pledging parcels of bills as security for the loans. On occasion they also sold parcels to the banks, particularly when a fall in the discount rate made the deal a profitable one. In any case, as they either endorsed the bills or in other manner took responsibility for seeing that the paper was duly honoured at maturity, the banks were usually content to take such bills at a finer rate than they would otherwise expect. It will be realised that the Houses became very skilful in the play and interplay of money rates, as well as in discrimination between sound bills and others. Hence the importance to them of the Bank Return, which in pre-War times they read

as a barometer in order to forecast the financial weather impending.

The money market of course could, and can, always resort to the Bank of England for accommodation, but as the terms of the latter are always more onerous it only does so when no alternative is available. So it comes about that the money market goes to the banks who lend to it their so regarded surplus funds, and as the bulk of this money is only lent for periods of a few days, and indeed much of it at call, the interest rates earned thereon by the banks are of a very low order indeed.

Bills of Exchange

Since the Great European War the bill of exchange in the purely home trade business has virtually disappeared and, although it persists in the overseas business, the volume has shrunk to a very small proportion of its former amplitude, indeed indicating the lamentable falling away of international trade in every direction. The place of the commercial bill in the portfolios of the banks and the market has however been taken by the Treasury Bill, which is issued by the Government department implied in its name. During the Great European War the figures of Treasury Bills swelled to colossal proportions and much of the unfunded Debt was financed by these instruments. The rate of interest obtainable on a Treasury Bill is appreciably lower even than that on a first-class bank commercial bill, and had the banks been unwilling to lend money at cheaper rates to the members of the money market, so enabling them to purchase Treasury Bills, the Discount Houses must inevitably have gone out of business during the long period of very cheap money.

It is not very obvious why the banks should altruistically have so supported the money market since they themselves are keen buyers of bills, and their actions have helped to force bill rates down by assisting competitive buyers in this manner. But British banks are

conservative institutions, and they have preferred to keep in being this reservoir into which they run their spare funds rather than lend directly to each other or actually to purchase all the bills themselves; instead, they allow the money market to deprive them of large volumes of the bills by the help of their own loans. Probably the root of their action lies in the fact that the big banks are not keen on disclosing their hands to rival institutions, added to which they never go to the Bank of England for assistance and do not wish to start the practice. These reasons however are not very convincing, and it is certain that they pay dearly for the satisfaction they derive from maintaining on their balance sheets £154·1 millions of 'Money at Call and Short Notice.'

Money held Abroad

'Balances with Banks Abroad' is a small item on our balance sheet of merely £2·8 millions. In truth, only two banks record them separately in their balance sheets and one of them alone, Lloyds, shows £2·6 millions. The other banks possibly include their figures with 'Money at Call and Short Notice.'

The banks being dealers in foreign exchange had to keep stocks of dollars in New York, francs in Paris, florins in Amsterdam, and so on, besides holding large amounts similarly on behalf of customers. The sterling book value of these balances at times amounted to considerable sums. They could always be turned into cash at a moment's notice by sale in the foreign exchange market. In fact a large part, or even the whole, might conceivably already have been sold for forward delivery at dates later than 31st December 1938. Lloyds Bank, having Indian branches, is in a peculiar position and probably keeps considerable sums with the Reserve Bank in India (the Central Bank of that country) in respect of its Rupee liabilities; this would account for the important amount of the item in its balance sheet.

Bills discounted

Following the common practice of placing the assets in order of liquidity, that is to say in order of ease in turning them into cash, we find that the next item on the balance sheet is 'Bills discounted, £233 millions.' Enough has been said in a preceding section to obviate the need for much explanation here. A bank's portfolio of bills will be well spread as regards the maturity dates since fresh ones are constantly being purchased, and few bills are drawn at a term of more than ninety days. Thus a bank merely has to refrain from buying fresh bills in order to have a steady stream of cash coming in daily as its holdings mature and in three months the whole would be almost entirely liquidated.

In practice the joint stock banks traditionally do not re-discount their bills, that is, they do not sell them to others as do the Discount Houses for instance, but in case of urgent extremity there is in reality nothing to prevent them from selling their unmatured holdings on the market or from re-discounting them with the Bank of England. A curious foible is met with in some banks in their unwillingness to show separately their holdings of Treasury Bills and of commercial bills; this is a pity, for more exact knowledge of the location of Treasury Bills would be highly useful to economists.

Investments

We now come to the 'Investments,' the large volume of which has prompted the view that the banks are now more akin to investment corporations than anything else. To a certain extent this is true, but owing to the lack of demand for commercial loans on anything like the scale necessary to equate the volume of money to the level required to keep prices steady, it has increasingly been necessary to purchase investments, as will be learned later. Naturally, the banks would prefer to make more extensive loans to industry if only for the reason that the yield obtainable is higher, added to

which, of course, there is no question of a market fall in the price requiring possibly a drastic writing down of the value of holdings.

Almost invariably the banks purchase short-dated securities issued by the British, Indian, Dominion, and Colonial governments or invest in British Municipal Corporation Stocks, the holdings in British Government Stocks overwhelmingly preponderating.

Here again the group of assets is comparatively liquid, since Government Stocks can be sold on the Stock Exchange in relatively large quantities without any serious break in the price, but of course, were blocks sold of the size required to adjust even everyday money movements in the great banks, some depreciation would be bound to ensue. In these circumstances the banks naturally never have recourse to pressure sales of stocks and in truth the necessity has not arisen in our time.

A word is desirable on the valuation of securities for balance-sheet purposes. Every bank's Statement bears the phrase 'at or under market value,' or equivalent words. It is a custom of the British banks not to write up the value of their securities, but they write them down if the market value recedes. Thus a useful hidden reserve may very well exist in this group of the assets. It is quite possible, however, that no writing down is effected when the value of certain component stocks is below the book value provided that the block as a whole is worth more than the book value. The serious problem facing the banks when a Stock Exchange slump in prices occurs may well be imagined with their holdings at the enormous figure of £627·4 millions.

Affiliated Banks

There is another class of investments held by many banks which nowadays must be shown separately on the balance sheet in order to conform with the Companies Act regulations. This consists of their holdings of shares in subsidiary concerns. It has been mentioned

before that Barclays adopted the indirect method of acquiring the Union Bank of Manchester Limited by purchasing the shares from the former shareholders. In similar manner others have acquired the whole or part of the capital in various Scottish banks, in Colonial or Dominion banks, or in banks operating on the Continent.

The following is a table showing the affiliations of the great banks:

Barclays Bank Limited.	<p>The British Linen Bank Limited. Barclays Bank (Dominion, Colonial and Overseas) (operates in South Africa, Egypt, West Coast of Africa, West Indies, etc.). Barclays Bank (France) Ltd. Barclays Bank S.A.I. (operates in Italy). Barclays Bank (Canada). Barclays Trust Company of Canada. Yorkshire Penny Bank Ltd.</p>
Lloyds Bank Limited.	<p>The National Bank of Scotland Ltd. Bank of London and South America Ltd. (operates in Argentine, Brazil, Chile, Uruguay, and South America generally). Lloyds and National Provincial Foreign Bank Ltd. (operates in France and Belgium). Bank of British West Africa Ltd. National Bank of New Zealand Ltd. Indian Premises Co. Ltd. (owns the Bank buildings housing its branches in India). Yorkshire Penny Bank Ltd.</p>
Midland Bank Ltd.	<p>Clydesdale Bank Ltd. North of Scotland Bank Ltd. Belfast Banking Co. Ltd. Yorkshire Penny Bank Ltd.</p>
National Provincial Bank Ltd.	<p>Coutts & Company. Grindlay & Co. Ltd. (operating in India). Lloyds & National Provincial Foreign Bank Ltd. Bank of British West Africa Ltd. Yorkshire Penny Bank Ltd.</p>
Westminster Bank Ltd.	<p>Westminster Foreign Bank Ltd. (operating in France and Belgium). Bank of British West Africa Ltd. Yorkshire Penny Bank Ltd.</p>
Martins.	<p>Yorkshire Penny Bank Ltd.</p>

Loans and Advances

Turning to the heading of 'Advances to Customers' we reach the most potent item of the balance sheet from the point of view alike of the commercial world and of the bank management. At the figure of £984·5 millions here is indeed a force which can be of splendid benefit to the nation or of catastrophe to the monetary system, according to the skill with which it is controlled. The first point to be noted is that although the proportion of advances to deposits is only 43 per cent., as against a figure in earlier times of 50 to 60 per cent., this merely means that the deposits have increased, through the growth of investment purchases, more rapidly than the advances. In truth the figure under present consideration is near the peak figure of the volume of advances which occurred in 1929 when it reached £991 millions, although it has since seriously declined as will be noted in due course. The magnitude of these figures indicates the responsibility which devolves upon the direction of the great banks, for were even a small percentage of the loans to become bad debts the result would be monetary chaos; a loss of 6 per cent. here would wipe out the reserve funds and 8 per cent. the paid-up capital. These facts should be borne in mind when criticisms are heard regarding the alleged unwillingness of the banks to lend on any but the best security. It will be realised later how the banks have a responsibility not only to their shareholders but to the community in general, by reason of their guarantee to depositors that their money shall be worth 20s. in the £.

The first requisite confronting bank directors is that their advances shall be well spread. The wide-flung network of branches to some extent automatically assists them in this, but it is easy to see that an individual bank through special connections could become involved to an excessive extent in, say, the colliery, the

steel, or the agricultural industries. The banks therefore must keep the wide view constantly before them, and however tempting propositions may appear there must come a moment, if wisdom reigns, when a request has to be turned down or referred to some competitive institution. Unfortunately the large banks are not very communicative as to the allocation of their commitments in the various industries; information on this score would be helpful to monetary research workers as well as to the leaders of the industries themselves. The chairman of Lloyds Bank Limited in this, as in other matters, has set an enlightened example by giving from time to time a well-detailed analysis of the advances. It cannot be assumed that the same proportions are valid for all the banks and it is to be hoped that some day all will publish, either voluntarily or if need be compulsorily, detailed analyses at reasonably frequent intervals.

Security for Loans

Financial and commercial loans are usually covered either by deposited Stock Exchange security or life policies, by the pledge of specific merchandise or of property, or by guarantees. In cases where the merchandise bought by means of bank loans consists of raw material which is in course of being utilised in the manufacture of finished articles, a charge upon, or a floating debenture over, the total assets of the customer may be accepted.

In some cases the borrower is a company whose balance sheet reveals a position of such undoubted strength that the bank does not insist upon a debenture or specific security; the loans or overdrafts then are given upon the bank's knowledge of the business and of the men conducting it. There are further a very large number of unsecured personal advances, but these are small in individual amount and are therefore well spread.

Long- and Short-Term Finance

It has been a canon of British banking for half a century or more that long-term loans should not be made, on the theory that such finance belongs more properly to fixed capital flotations. Temporary advances in anticipation of such finance, it is true, are made, but on the understanding that they will be repaid later out of the proceeds of a capital issue. Experience has shown the wisdom of the rule, and the superior liquidity of the British banks as compared with German or American institutions is largely due to the tenet that since the deposits of a bank are mainly short-term money, advances should similarly only be made on short-term conditions. It is a fact that historically the great bank failures and difficulties have almost invariably been due to neglect of this principle. If, therefore, your bank manager one day refuses your application for a very long term loan which you require to assist in the purchase of a house, and refers you to a building society, you will realise the principle underlying the apparently unaccommodating attitude. The banks prefer always to make loans which are constantly turning over, or so-called self-liquidating advances, which explains why they have always been keen on the discounting of bills, for these have their dates of payment specifically designated.

Bank Premises

The only fixed asset upon the banks' balance sheets is that of 'Bank Premises.' At the figure of nearly £44 millions it seems a very large lock-up, but when it is remembered that the banks between them have over 10,200 offices, of which 1189 are in London, including the palatial head offices, each of which must have cost anything up to a million and a half to build, it will be seen that the figure is the reverse of extravagant. When the fact is taken into consideration that the London sites were bought in many cases as far back as a century

ago, and no value is ever written up, it will be seen that the item 'Bank Premises' hides very considerable reserves indeed. So far from values being written up, each year sees a very substantial figure transferred from Profit and Loss Account to write down this asset.

Contingent Liabilities

The final item on the balance sheet to discuss is the one which appears with an identical figure on both sides, under 'Acceptances, Endorsements, Guarantees, and other Obligations' on the Liabilities, and 'Liabilities of Customers for Acceptances, etc.,' on the Assets side. Unfortunately the practice of the banks varies so greatly in this connection that the figure of 128.8 millions on our combined balance sheet does not convey a great deal. The broad fact that the banks have entered into certain obligations on behalf of customers is stated on the liabilities side, whilst the customers' responsibility to the banks in respect of these obligations is recorded on the assets side of the balance sheet. These obligations are many and varied, and whilst one bank may include one group of them in its contingent liability figures, others may feature quite a different selection. Thus Lloyds Bank Ltd., with a total of £40 millions, must include nearly every obligation possible, whilst Barclays and the Midland only show £15 and £17 millions respectively. Clearly the three banks have quite distinctive ideas of the term.

The first item of the group, 'Acceptances,' is one however which is common to all, and refers to bills of exchange upon which the banks have placed their signature in token of their acceptance of the request to make themselves liable to pay the amount upon the due date. More will be read in other chapters of the circumstances which give rise to these acceptances, so it is unnecessary to discuss them here in any detail. It is sufficient for the moment to say that these acceptances are the most direct obligations of the whole group.

'Endorsements' requiring entries in the bank's balance sheets are infrequent. An example arises, however, when bills in foreign currencies are negotiated for customers and then re-discounted abroad with the bank's agent. As such bills are endorsed by the bank, the liability to the foreign agent for their ultimate payment must be recorded, as must, per contra, the liability of the customer to the bank.

Many and varied forms of 'guarantees' arise in which the banks are asked to join. Included amongst these are ship's bail bonds, undertakings to the Customs and Excise in respect of duties or for due payment of cheques tendered in settlement of such duties, guarantees to other banks in respect of other people's overdrafts given on behalf of customers, or bonds which contractor customers sometimes have to give duly backed by a bank, for due fulfilment of particular contracts.

Amongst the series of 'Other Obligations' are those arising out of 'confirmed bankers credits' whereby the bank gives its undertaking to pay for, or give its acceptance against delivery of, shipping documents on behalf of a customer. But the most sizable figures under this heading arise out of Forward Foreign Exchange contracts, and it is probable that here lies the main difference between the practice of different banks. The transactions will be explained in a later chapter but it may be said shortly here that they arise when the bank makes a contract with a customer to sell to him, or buy from him, foreign currencies at a future date. The risk is only a marginal one, dependent upon movements of the exchange adverse to the contract in the period prior to fulfilment. The bank having bought, say, dollars from a customer deliverable in a month's time might sell a similar amount in the market in order to keep its books square, or of course it might only deal in the market with a net amount balancing a series of transactions. Some banks ignore forward contracts altogether in their balance sheets, others pass entries for the total of all

contracts whether bought or sold, whilst others again pass entries for either the bought or the sold side but not in respect of both. Possibly some record in the balance sheet only contracts entered into with customers, as distinct from market deals. However, during the present World War, foreign exchange business has entirely changed in character, as will be shown in the appropriate chapter.

To conclude the general question of obligations, it is necessary to add that the banks weigh carefully the risks involved, and if these are considered onerous they take such security from the customer as is thought adequate for their self-protection.

The Scottish Banks

The history and practice of the English banks has been dealt with as exhaustively as possible within the limits of the allotted space, but this chapter would be incomplete if a description, however slight, of the highly important Scottish banking system were omitted.

The Bank of Scotland was founded only a few years after the Bank of England, receiving its charter in 1695 and commencing business the following year. At the expiry in 1727 of the monopoly which had been granted to it, a rival, the Royal Bank of Scotland, obtained its Charter. As in England, a large number of private banks sprang up, and perhaps the most famous of them was John Coutts & Co., the first private bank in Edinburgh. This started in 1723 but at that early date was probably purely a merchanting business. In 1761, however, the trading side was discontinued in favour of the banking activities. Shortly afterwards a branch was opened in London, which later developed independently into the famous banking business of Coutts & Co. The Scottish end changed its name in 1773 and a century later was merged into the business of the Union Bank of Scotland.

In 1746 the third great Scottish bank received its

Charter under the name of the British Linen Company. It transacted mercantile business as well as banking until 1763, when it withdrew from all its trading activities and concentrated upon banking. Its name was later changed to the British Linen Bank.

Many other banks, both private and joint stock, started business in the eighteenth century, but they were of small importance as compared with those mentioned above. In 1810, however, the Commercial Bank of Scotland and in 1825 the National Bank of Scotland were founded. The Town and County Bank also started in 1828, followed in 1836 by the North of Scotland Bank (these two subsequently amalgamated under the clumsy title of North of Scotland and Town and County Bank Limited) and in 1838 the Clydesdale Bank was established. In 1843 the Union Bank of Scotland commenced business; this was an amalgamation of several banks which had been founded in 1830 and onwards.

It will be seen that nearly all the Scottish banks had acquired long experience before the London joint stock banks were even founded, three indeed by then having existed almost a century.

The Scottish Note Issue

In 1844 the Scottish banks, all of which were banks of note issue, did not escape the attention of Sir Robert Peel. Just as in the case of the English country banks, their average issues were fixed in the Scottish Bank Act of 1844 as their future fiduciary limits, and any excess was to be covered by gold and silver coin (the latter limited to one-fourth of the gold). Nowadays, however, cover in Bank of England notes is the rule. Their existing right to issue £1 notes was confirmed and amalgamating banks were permitted to retain their joint fiduciary limits. Lapsed issues, however, disappeared entirely, and not even the Bank of Scotland could claim any proportion of them.

Except for the Old Bank, as the Bank of Scotland is

popularly designated, the Royal and the Linen banks, whose liabilities were limited by the terms of their charters, the banks were unlimited. The appalling failure of the City of Glasgow Bank in 1878, which has been mentioned earlier, forced the issue of limited liability in Scotland, as it did in the case of the English concerns, with the result that non-chartered banks adopted the principle by registration under the subsequent Acts.

Amalgamations and Acquisitions

The history of the Scottish banks, as in England, has been one of amalgamation, the Union Bank of Scotland, as befits its name, having been particularly active in this direction. The result is that the business in Scotland is now practically confined to the eight large concerns which have already been mentioned. In 1918, however, a new development occurred. Lloyds Bank Limited offered the shareholders of the National Bank of Scotland Limited such tempting terms that the majority exchanged their shares for those of Lloyds Bank Limited, and thus the control of a leading Scottish Bank passed into English hands. In the following year, and in similar manner, the British Linen Bank passed into the control of Barclays Bank Limited, and the Clydesdale Bank to the Midland Bank Limited. Finally, in 1923, the North of Scotland Bank was also acquired by the Midland Bank. All these concerns still carry on business in their historic names and with independent boards, upon which, however, the controlling English banks have their representatives.

As a counter-stroke to this English invasion of Scotland the Royal Bank of Scotland absorbed one of the oldest London private banks, Drummond & Co., shortly after 1918, and, as has already been mentioned, in 1930 they acquired the control of Williams Deacons Bank Limited and in 1939 of Glyn Mills and Co.

The paid-up capital of the Scottish banks on 31st

December 1938 was £14,821,192 and their reserves amounted to £18,710,965; it is unusual to find the reserves exceeding the paid-up capital and it exhibits the very strong position of the Scottish institutions. The notes issued amounted to approximately £24 millions against the fiduciary limit of £2,676,350.

The principal remaining figures on 31st December 1938 are tabulated below for ready reference:

Deposits	£328,600,881	
Cash in hand, Cheques in course of collection, and Money at Call and Short Notice.	80,354,359	{ Some banks quote the figures together, so that it is impossible to give separate details.
Investments	187,122,247	
Investments in Affiliations	3,093,750	(Royal Bank of Scotland.)
Discounts and Advances	114,107,235	(One bank shows both categories together.)
Net Profits	2,762,151	
Amount paid in Dividend	1,719,716	

The Agents

The Scottish banks have certain peculiarities in their systems as compared with the English banks. One of these is that the Agents, as the branch managers are called, are not necessarily officers who have been reared and trained in the service of the bank. They are often local solicitors of standing, whose intimate connections with the lives of their towns are of great value from the point of view of the safety of advances, for they are thoroughly conversant with the character, means, and standing of the obligants to the banks.

Cash Credit System

Another Scottish custom, of ancient tradition, is that of the 'Cash Credit' method. This consists of granting to able and energetic customers of character a limit up to which they may overdraw their accounts, such maximum amount being guaranteed by two persons of standing. This arrangement has been of particular service in developing Scotland from a poor aggregation

of crofters into a well-organised and industrial nation, for the persons of ability were ever without the means necessary to utilise their tenacious genius and so were unable to place with the bank the negotiable security usually required in such circumstances.

This custom of accepting the guarantee bonds of wealthy third parties, which grew up with the Scottish banks, has been a highly successful mode of finance. The procedure leaves the primary responsibility for the advances with the poor but able industrialist, whilst it secures the bank reasonably well should his plans go awry. The method is quite peculiar to Scotland, and perhaps arose through the canniness of the industrialist who would more willingly pay a guarantee commission than take a moneyed partner into his business. Perhaps also the guarantors often preferred to give their bonds for specific sums rather than undertake the unlimited obligations attaching to partnership.

It is perhaps to this distinctive class of banking that the old system of appointing lawyers as the Agents is partly due, for none is better able to judge the worth of the guarantor than the family firm of solicitors which has handled the affairs of the town for generations.

The success of Scottish industrialism owes much to the co-operation and genius for finance of the indigenous banker, who, let it be admitted at once, has made his mark not only in his own country but in the wide field of imperial finance. The Scotsman is to be found directing or working in the banking concerns of India, Africa, Australasia, and indeed throughout the British Empire, as well as in the East generally, and wherever he goes he endeavours to graft upon the local customs, in some form or another, the practice which he learned in his apprentice days—the Cash Credit System.

Chapter V

THE MERCHANT-BANKER: THE IMPERIAL AND FOREIGN BANKS

It is almost commonplace to remark that the industrial revolution made Britain the workshop of the world, but it is scarcely less true to say that the world demand for British goods not only assisted manufacturers to produce ever better and cheaper wares, but also made London the financial centre of the modern world.

In these circumstances of thriving overseas trade it was natural that in the early nineteenth century existing mercantile houses as well as new ones springing up should become wealthy by their activities in exporting these multitudinous goods, and importing the produce which paid for them, in so far as they were not paid for by loans raised in this country. As the history of banking everywhere shows, the merchant often became also the banker, who later found it advantageous entirely to discontinue the trading side of his business.

Acceptance Houses

With their overseas organisations of branches or agencies these merchants were in an excellent position to handle the financial side, as well as to supervise the shipping of the goods, on behalf of customers who resorted to them both in Britain as well as in those countries in which they specialised. Shippers therefore, in both directions, entrusted them with the task of collecting payment for their exported goods. If the customers desired advances in anticipation of the receipt of the proceeds of their collections, the merchant-banker would doubtless be willing to oblige since he held the goods as security, and could reimburse himself sooner or later out of the sales realisations. But of

course the means of the bankers were not unlimited, and as their connections grew there would come a time when their cash resources would not allow them to grant further direct finance. There then gradually evolved the method of finance by 'acceptances': that is, by the merchant bank giving its acceptance to a bill of exchange drawn by the shipper of the goods for the amount of the finance required by him. Hence the alternative name of 'Acceptance Houses' which is applied to the merchant-bankers in London. The shipper then could readily sell the bill for cash to a local banker or to a house specialising in the buying of bills of exchange.

Many of the former trading but now merchant banking houses had acquired world-wide reputations, and as the demand for British goods in those nineteenth-century days was normally so insistent, foreign buyers had to take the onus of the finance. It became common therefore for such buyers to approach these London bankers, either direct or through the intermediary of their own local bankers, in order to make the monetary arrangements.

Foreign Trade Finance

A typical transaction of this kind will make clear the procedure. A Brazilian buyer having ordered a consignment of, say, cutlery from Sheffield, the seller demands either cash in advance or some valid assurance that the goods will be duly taken over and paid for, before he is willing to commence to manufacture. The foreigner thereupon goes to his bank in Rio de Janeiro and asks them to arrange a credit on his behalf in London by virtue of which an undertaking will be given to the Sheffield maker, assuring him that, if on or before a stated date he produces shipping documents covering the ordered consignment, he will be entitled to the fulfilment of the financial arrangements established for his benefit. This the Rio bank does through its correspondent, an acceptance house, in London.

In possession of this assurance from the London merchant bank, the Sheffield man manufactures the goods, and in due time sends them to a port to be shipped to Brazil, receiving in exchange a bill of lading which, in effect, is a receipt for the goods signed by the ship's captain, the possession of which denotes the title to the goods designated. The bill of lading, together with an insurance policy covering the voyage and invoices made out for the contract price, is attached to a bill drawn by the manufacturer, perhaps payable three months hence, upon the merchant-banker for the invoice amount and sent to the latter for acceptance.

After examination has confirmed that everything is in accordance with the instructions received from Brazil the banker accepts the bill by signing his name across the face of it, and returns it to Sheffield, where the drawer will have no difficulty in getting his local bank to discount such excellent paper and he will therefore receive the face value of it less the appropriate amount of interest involved by the prepayment.

The merchant-banker for his part sends the shipping documents to the Brazilian bank, which will then proceed to collect the value of the goods from the buyer, or it may deal with the documents in any way it pleases, so long as the value is received back in London in time to meet the banker's acceptance when it falls due. The Brazilian bank thus may deliver the documents or goods to the importer either against cash or, if he is considered a good credit risk, against his promise to pay the value when he has sold the cutlery to others.

The transaction is satisfactory to all parties, for the seller in Sheffield obtains an acceptance which he can transmute into cash whenever he pleases; the buyer in Brazil has no need to pay for the goods until they arrive, or even until they are sold; the merchant-banker receives an adequate commission from Brazil for his services in aiding the finance which, as will be realised, consists of little more than lending his signature to a

bill of exchange upon which his name, in effect, has been substituted for that of the Brazilian buyer; the Brazilian bank obtains its remuneration by way of charges from its customer as well as by the profit from an exchange transaction whereby it sells to the customer for milreis the sterling which has to be remitted to London.

It should not be assumed from the foregoing example that Yorkshiremen never trust Brazilians to honour their contracts or that Brazilians are never sure that Englishmen will deliver goods according to arrangement. On the contrary, an enormous volume of business is transacted without the need for a 'credit' guarantee by the merchant-banker, but the Sheffield man may, nevertheless, still ask financial assistance of him. After the goods have been shipped the banker will be quite willing to grant his acceptance to the manufacturer against delivery of the shipping documents as before, but this time the manufacturer will be his principal instead of a Brazilian bank, and will undertake to place the banker in funds to meet the acceptance on the due date should the proceeds not have been collected from Brazil in exchange for the shipping documents by then.

In a similar manner a foreign seller might ship his produce to London or Liverpool, drawing a bill upon a London merchant-banker by previous arrangement, and sending the documents to the latter or attaching them to the bill. The foreigner will have no difficulty whatever in selling such an excellent sterling bill to a local banker in exchange for his own currency. The merchant-banker will collect the invoice value from the British importer against delivery of the documents or goods, and is thus placed in funds to meet his acceptance at maturity.

The London Acceptance

In course of time this function of the merchant-banker spread wider and wider, until the sterling London acceptance became the international currency the world

over, even for transactions which never actually touched our shores. A further example will illustrate this.

If a South American coffee-grower desired to buy jute bags in Calcutta he would have difficulty in finding a seller of rupees in Brazil to enable him to pay for the goods, just as the Indian would not easily find a purchaser for a bill drawn by him on the coffee-grower in milreis. But by virtue of the intimate connection of London with both countries the Brazilian could as readily purchase sterling as the Indian could sell it. Therefore the position gradually evolved that the convenience of both parties required such a buyer to get his local bank to arrange an acceptance credit with a London bank to cover the specific transaction. In a similar way, the Chinaman financed his sales of tea to a Russian or to a Peruvian; the Australian his wool to a Roumanian or a Japanese; the Finn his timber to a South African or a Tunisian. In such manner was the supremacy of sterling and London finance built up until the world at large paid toll to the British banking system for its services to international trade.

In time the merchant-bankers, now wealthy and internationally respected, extended their activities to yet further fields, and became the intermediaries whereby foreign governments, municipalities, and public undertakings raised loans in London. Colossal sums were so negotiated and the transactions added to the fame and pecuniary advantage of the issuing houses. Thus it was that such names as Baring, Rothschild, Schröder, Morgan Grenfell, Kleinwort, Brown Shipley, Erlanger, Samuel, and Hambro, to mention only a few of many, sprang into prominence and financial power during the last century.

International Finance in 1914

At the outbreak of the Great European War in 1914 enormous figures were outstanding in respect of merchant-bankers' acceptances, amounting to many times their

capital. As many of these obligations were made on behalf of customers who had then become enemy debtors, or of others whose businesses were badly deranged by the hostilities, it became essential for the Government to assist the Acceptance Houses if widespread bankruptcy and collapse were to be avoided. This was done by the Bank of England, who financed the bills under the guarantee of the Government, placing them in 'cold storage' until repayment could be made by means of the 'Enemy Debt Clearing' or other settlements. In the event, the Acceptance Houses cleared off every bill and not a penny was lost by the Government in this respect.

The German Default

In 1931 the debacle of German credit involved not only the Acceptance Houses but also the joint stock banks, which, after the War, had entered into the acceptance business on a much larger scale than they had done prior to 1914. Not only in this country but in America, Holland, Switzerland, and elsewhere the banks were badly hit by the German default. And cleverly did the government of that country turn the occasion to the advantage of its export trades by adroit handling of the 'blocked' mark system, of which, however, more hereafter. It is certain that the Acceptance Houses have suffered a decided set-back during the past decade or more, since their interests lie so overwhelmingly in the international sphere. The shrinkage of overseas trade, coupled with the almost complete cessation of new foreign loans and default upon many existing ones, has dealt a severe blow to these houses, formerly supreme in their class. And now the World War has hit them still more severely.

Fortunately the team spirit and harmonious understanding which undoubtedly pervades the London money market, using the term in its widest sense, tided over the worst phase occasioned by the German default,

and consequent lock-up of resources. Should international trade revive, it may be regarded as certain that the merchant-bankers will speedily regain much of their old importance. It would indeed be a pity were matters to befall otherwise, for generations of experience and skill would be dissipated and lost.

The Imperial Banks

The same influences that fostered the merchant banks caused very important groups of institutions to spring up throughout the course of the nineteenth century. These were English banking corporations having head offices or branches in London, and offices in the colonies (later the Dominions) and dependencies, as well as in India and the Far Eastern centres, whose trade they were designed to assist. To this movement we owe the great Canadian, the Australasian, the African, the Egyptian, and the Eastern Exchange banks, whose activities have been of such immense aid to Empire trade as well as of profit to themselves. There are thus six large concerns operating throughout Canada and eleven throughout Australia and New Zealand, whilst the group of Eastern Exchange banks (included in which are the Indian branches of Lloyds Bank Limited) operated extensively in India, Burma, China, Malay, Siam, Straits Settlements, and other Eastern countries, as well as to some extent on the east coast of Africa.

The Imperial banks have not been exempt from the urge to amalgamate and absorb. The most notable example of this movement is provided by Barclays Bank (Dominion, Colonial & Overseas), which is a fusion of the National Bank of South Africa Ltd., the Colonial Bank (operating in the West Indies and on the West Coast of Africa), and the Anglo-Egyptian Bank Ltd., and which has affiliations in Barclays Bank (France) Ltd., Barclays Bank (S.A.I.) Ltd. (Italy), and Barclays Bank (Canada) Ltd.

There is no space here further to particularise these

many Imperial concerns, but their vast importance may be taken for granted not only in the financing of overseas trade, but in the domestic development of the countries in which they are established; they have a record of service of which they may justly be proud.

The Anglo-Foreign Banks and Others

The remaining banks in London are of two categories. The first, the Anglo-foreign concerns, comprises those such as (a) the Bank of London and South America Ltd. (now an affiliation of Lloyds Bank Limited), which has branches throughout the South American republics, and which a few years ago absorbed the considerable Anglo-South American Bank Ltd., and (b) the Imperial Bank of Iran, with branches in that country, and (c) institutions having specialised connections with Continental interests. The second category is the very extensive one of the branches of foreign banks established in London in order to assist the financial relations of their own countries, not only with Great Britain, but also with the world in general, which can only be done through the intermediary of London by virtue of its position as the financial centre of the world. Thus we find here several branches each of American, French, Belgian, Japanese, and Italian banks (the two latter groups of course now liquidated), whilst many other countries have a single branch of one of their banks in London. Before the 1914 War there were several German and Austrian banks who established here very active and powerful branches, but they were naturally wound up during hostilities and their property sequestered for the benefit of the Enemy Debt fund. They have never since been reopened.

All these units, joint stock banks, Scottish banks, private banks, merchant banks and acceptance houses, discount houses, Imperial and colonial banks, Anglo-foreign banks and foreign banks, mostly within a stone's-throw of the Bank of England, or at all events within

the 'square mile,' work with the minimum of restraint and control, with perfect freedom of judgment, yet with a sense of national and international responsibility and an *esprit de corps* which is impressive in its unanimity. Should danger threaten one section or group, all band themselves together under the leadership of the Old Lady of Threadneedle Street—as the Bank of England is affectionately called—to take appropriate action to combat the danger or to tide over the effects if the cause cannot be removed.

The London money market, in the very widest sense of that term, is an almost perfect example of self-governing democratic business. Rarely indeed has an intransigent member to be called to order, but if the need arises the offender is quickly made to realise his position, and he soon recedes from his attitude of nonconformity with the principles of safe finance.

Chapter VI

BILLS OF EXCHANGE AND CHEQUES

IN the course of the previous chapters, mention of the bill of exchange has inevitably recurred; inevitably because the bill is and always has been the instrument *par excellence* for conducting trade and for transferring money from one party to another.

As mentioned already, the Egibi tablets provide the earliest example of the bill of exchange, for the one issued by this Babylon firm upon its Orchoe correspondent, instructing the latter to pay a *specified sum of money to a third party, was a perfect instrument and in a form which has persisted throughout the intervening centuries.

In its earliest origin it was probably a written form of receipt for money or materials when these were entrusted to the writer or giver of the acknowledgment. As safe-custody banking developed, this receipt became extended in function to cover a promise to repay, either upon demand or after a stated period of time; in other words, a promissory note had evolved. We have seen also how this class of receipt became a bank note.

Bills as Finance Media

The function of transfer constantly developed until it made the bill of exchange a medium of trade credit. When a seller parted with his goods and was content to allow the buyer to defer payment, he could let the resultant debt remain upon unacknowledged open account, but it was fairer and avoided subsequent dispute if the buyer gave his written promissory note to the seller for the agreed price of the goods.

But it frequently happened that, by giving extended credit in this manner, the seller so locked up his resources that he was precluded from entering into further

favourable transactions for lack of the necessary funds. Then he had recourse to a banker, asking the latter to purchase the obligations of his buyers as evidenced by the promissory notes. If the banker were satisfied as to the wealth and integrity of the obligants he might purchase the instruments, but only provided he obtained the responsibility in writing of his customer in addition to that of the signers of the instruments. In other words, he would want at least two names; that of the primary obligant (the buyer of the goods) as well as that of the customer on each bill. Thus it was found convenient to discard the promissory note in the case of sales of goods and adopt the transfer form of bill of exchange. This form, in essentials, gradually crystallised into an almost common phraseology all over the mercantile world, and the various codes of law passed by different nations have, by definition, given statutory force to the instrument.

Here, then, is a typical modern bill of exchange:

REVENUE STAMP FOR 10/-	<u>£1,000</u>	London, 1st January 1943.
Three months after date pay to the order of ourselves the sum of One Thousand Pounds sterling for the value received.		
		JOHN GENEROUS & CO. (signature)
To Messrs RICHARD TRUSTWORTHY & SONS, 5090 Esperance Street, Manchester.		

J. Generous & Co., sellers of the goods, draw the bill upon Messrs Trustworthy & Sons, the buyers. The former are therefore the 'drawers' and the latter the 'drawees,' who, when they signify their acceptance of the terms of the drawing by writing their signature transversely upon the bill, become also the 'acceptors.'

The Form of a Bill

The specimen shows the basic form of the bill of exchange. There may be slight variations in detail, but it is essential (a) for a specific or deducible date of payment to be indicated (one dependent upon a contingency, such as 'on arrival of the s.s. *Good Hope*,' is not permissible), (b) for the amount in money to be unequivocally stated, and (c) for the bill to be payable to or to the order of a specified person, who may be the drawer himself, or alternatively to 'bearer.' In the specimen given, the bill is due on 4th April, that is, three months after 1st January, plus the three days of grace customary in Great Britain, and accepted payable at the bank of the drawee, at which place it should be presented for payment on that date.

As mentioned above, in the eighteenth and nineteenth centuries the bill of exchange was very widely used when sales of goods in the home trade were made on credit terms, and accordingly when the holder of the bill wanted financial accommodation he always tendered his bills to the bank for discount. That is not to say, of course, that the banker invariably agreed; he might require another and better name upon the bill or he might require the deposit of collateral security where the bills were not 'first-class trade paper.'

'Kite-Flying'

In this connection it may be mentioned that the practice of discounting bills sometimes facilitates the 'raising of the wind' in quite illegitimate circumstances. A needy merchant persuades a compliant person, usually for a consideration, to agree to become the drawee of a bill and to accept it, on the understanding that the necessitous one will duly provide the funds to meet it at maturity. He discounts it with his banker and thus has funds for the duration of the bill with which to finance himself, although the instrument does not represent a real transaction. More venturesome

still, the two persons might draw bills on each other and get their respective bankers to discount both, so raising a double quantity of illegitimate finance.

Such bills are called 'accommodation bills' and the practice is picturesquely called 'kite-flying.' Transactions of this nature are only resorted to when the practitioners are in financial difficulties and they generally lead to a 'sticky' end. Bankers therefore avoid 'kites' as the plague, and at the first suspicion of them will see the 'red light.' Whilst a customer may succeed in the primary move, the banker rarely fails to detect the practice in the long run and he takes drastic and appropriate action.

There is an amusing story of a bill-broker who handed a parcel of bills to an old and experienced banker. The latter picked out a bill which was ostensibly drawn abroad, smelt it, and handed it back to the broker, rejecting it with the comment, 'That bill has never crossed the sea.' After the latter had departed a mystified subordinate asked the banker how he could tell a 'kite' by its smell, and was informed 'As a matter of fact the bill was not creased and consequently it has never been sent by post, although it is dated in Buenos Aires.' It is a good story and deserves to be true, although in all probability it is not, since bills with documents attached are generally sent in bulk in very large envelopes by the remitting banks.

To turn to the case of foreign trade, an account has already been given of the manner in which the bills arise. These being accepted by merchant-bankers or by joint stock banks or by London offices of the Imperial banks are considered in the market as 'prime bills,' and therefore they command a much finer rate for discount purposes than mere trade bills.

The Bills of Exchange Act

The laws of this country relating to bills were many and varied until 1882, when they were codified into a

new Act which is a marvel of clear thinking and brilliant draughtsmanship. This Act has stood the test of time and only three slight amendments to meet changing circumstances have been found necessary since it was placed upon the Statute Book.

The Cheque

The cheque is, by definition under the Act, a bill of exchange, and a moment's consideration will show that, in form, it is equally a bill. It is drawn by one person upon another to the order of a third party or to bearer, and it is for a 'sum certain in money'; it is also 'payable on demand.' The only characteristics of a cheque distinguishing it from other forms of bills of exchange are, firstly, that it is always payable on demand and, secondly, that the drawee is invariably a bank. The earliest forms of cheques which are still preserved in this country are letters addressed to the two goldsmiths Richard Hoare and Francis Child by their customers, desiring them to be good enough to pay to designated payees the various sums indicated. These letters are subscribed 'Your loving friend' followed by the signature of the customer. The cheques which we draw upon our bankers to-day, although they are couched in less affectionate language and are made out on printed forms with the more imperative direction 'Pay . . .,' are in no way different in essentials from these seventeenth-century missives.

Crossings

Since that time, however, certain customs have grown up, the principal one being the practice of crossing a cheque. This arose from the precautionary measure of indicating on the cheque the banker of the payee with the intention that nobody other than that bank should be able to collect the money from the bank upon which it was drawn. The habit of writing the name of the payee's bank transversely across the face of the cheque

gave rise to the word 'crossing,' and the addition of the two parallel lines, on either side of the name of the bank, was possibly intended to make the crossing more obvious and less likely to be overlooked by any person concerned. The effect of the drawee banker thus being prohibited from paying the cheque to any person other than the banker to whom it was crossed was clearly a safeguard in case the cheque should be lost or stolen; for any person wrongfully endeavouring to obtain payment in such circumstances could not obtain cash over the counter from the drawee bank, and it is unlikely that such a dishonest person in those early days would have a banking account, let alone one at the particular bank designated.

So the custom became a general habit, and if the drawer of the cheque were unaware of the name of his payee's banker he simply drew the two parallel lines and added the words 'and Company,' which was notice to all concerned that the cheque must only be presented through some bank or other, thus making it easy to trace a wrongdoer. Incidentally, the choice of the words '& Co.' give an idea of the early genesis of this practice, for these were generally the last two words of the name of a private banking partnership. A later origin would probably have evolved '... Bank' or '... Banking Company.'

Negotiability

Another custom surrounding bills and cheques was that of investing them with the attribute of negotiability. This property is the quality they possess of conferring upon a holder for value a perfectly good right to the money represented by the instrument, even though a previous holder may have had a defective title, provided that the first-mentioned had no knowledge of the defect. Thus suppose a cheque to bearer, or to order and correctly endorsed by the payee, were lost or stolen and a person subsequently came into possession of it, for

value in good faith and innocent of the circumstance, he could insist upon payment being made by the drawer, and the monetary loss would have to fall upon the party from whom the cheque was stolen or wrongfully obtained. It is this same quality of negotiability which makes secure your right to a £1 note which you receive in good faith, although that note may have been lost by, or stolen from, an earlier possessor.

It should be mentioned that the words 'Pay . . . or order' on a cheque or bill recognise that the payee may pass it on to another party, and the drawee by paying it to that party acknowledges the order of the payee. If the instrument reads 'Pay . . . or bearer' any holder may demand payment and he need not endorse it with his signature.

The Act of 1882 confirmed the custom of crossing and the property of negotiability, although it also gave sanction to the right of a party to a cheque to add words to the crossing, such as 'Not Negotiable' or 'Not Transferable,' which took away the attribute described. The presence of such addition to the crossing, however, does not prohibit the act of transfer, but it does prevent the holder from acquiring a better title to the cheque than that of his predecessor. If such a cheque had been stolen before being passed on to you, you would not be entitled to enforce payment as against the drawer. The phrase can be found on any postal order; if therefore you accept one from a stranger in payment you run the risk of losing your money if at any time it has been lost or stolen. So far as cheques are concerned, a non-negotiable crossing does not greatly affect them nowadays, for fewer people pass on cheques from hand to hand than was formerly the case; most payees now have banking accounts of their own into which they immediately pay them, so that the question does not therefore so frequently arise.

It is important to note, however, that in no circumstances can there be any question of negotiability if an

endorsement has been forged. So that if you lost a cheque payable to you, which you had not endorsed, and a miscreant finder forged your endorsement before passing it on to another party, the latter could derive no title on the grounds of negotiability and you would not necessarily lose your money. Naturally, however, to avoid the possibility of litigation, you would take the precaution of asking the drawer to stop payment of the cheque.

The Act of 1882 is primarily designed to codify the law as it affects the various parties to bills and cheques—the drawer, drawee, payee, collecting banker, and others—and fixes the responsibility in the event of various occurrences. To give an example, the drawee bank is responsible if it pays a cheque, the drawer's signature to which has been forged, or if the amount of an otherwise good cheque has been fraudulently raised, but the drawer would be responsible in the latter case if his carelessness in drawing it had assisted the wrongdoer to perpetrate the fraud.

There are one hundred sections in this important Act but it is unnecessary to inflict more of them upon the non-banker reader than those discussed above. But if it should be of interest, a study of this excellent piece of legislation will provide a fine intellectual whetstone upon which to sharpen the mental processes.

Chapter VII

THE QUANTITY THEORY OF MONEY

FROM very early times in the world's monetary history it had been observed that when there are in circulation large quantities of effective money, of whatever nature, be it silver, gold, paper, or bank balances, the prices of commodities rise. This phenomenon gave rise to what is called the 'Quantity Theory of Money.' In its crudest form the theory stated that prices in general varied according to the relationship between the quantity of money on the one hand, and the volume of goods available for consumption on the other. In other words, that prices vary directly with the fraction:

$$\frac{\text{Quantity of money}}{\text{Volume of goods}}.$$

Before proceeding further, we must discuss the question of what is money, and there will be found infinite variety in the answers to this question. Some would define it as gold and silver in the Bank of England and coin in the hands of the banks and public; others say the gold, silver, and all bank notes in total, whilst some of these omit the gold from the last group; yet another definition gives notes, coinage, cheques, and bills in circulation, whilst again others believe that all notes, coinage, and bank balances constitute money; some of the latter thinkers, however, exclude those bank balances which lie on deposit accounts. In this multiplicity of beliefs it is difficult to arrive at a just conclusion, but yet another one will be put forward here for consideration.

Money Defined

It has to be recollected first of all that the notes held by the banking department of the Bank of England are

not exchanged for commodities, but form the basis on which the Bank issues credit. They shall therefore be rejected as money. Part of the credit mentioned is held on Government account, and is disbursed by the public departments, being thus exchanged for goods and services; it may therefore be included as money. Another part, however, stands to the credit of the banks, and is not so disbursed, but forms the basis upon which *they* make their issues of credit: this part, as well as the notes, may, therefore, be ignored for our purpose, as may also perhaps the amount which is held by the Bank of England on 'other accounts,' since these funds are probably mostly owned by the foreign central banks and the money market, and likewise are not used to purchase commodities.

Turning to the banks, the notes and coins in their tills are static, since these are part of the medium upon which they base issues of credit; this till-money must, therefore, be eliminated. Again, since cheques cannot be drawn upon deposit accounts, such funds, if required to be spent, having to be transferred to current account, we may ignore deposit accounts in our calculations of effective money. As to funds on current account, we are faced with a difficulty, since many customers do not trouble to transfer their surplus money to a deposit account, but leave it idle and undrawn; the effective money is, therefore, something less than the whole, but it is idle to guess the proportions. One can only, therefore, take the whole, trusting that the hoarded money remains in a fairly constant proportion and may therefore be ignored for purposes of comparison. Unfortunately one cannot be too hopeful on this score, as undoubtedly here very serious variations can and do occur, but it is the best we can do in the circumstances.

Funds in the Post Office and other Savings banks can also be ignored, since they are of the same order as deposit accounts, withdrawals are made if spending is

the object and these have the effect of increasing the notes and coin held by the public.

We therefore find that on the basis suggested above money consists of:

Notes and coin in the hands of the public;

Current accounts at the banks;

Public deposits with the Bank of England.

Colour is certainly lent to the simple form of the quantity theory by the fact that in times when much more money has been created it has been observed that prices in general have risen considerably. Thus, for example, when fresh goldfields were discovered, as in the Klondike, in California, and South Africa, such an increase in money took place, for under a Gold Standard money is automatically created when gold flows into the Central banks, as we shall see in the chapter on the Gold Standard. In graphs which severally plot the curves of gold output and those of price-levels, the same bulges appear concurrently in both with remarkable fidelity, showing that, broadly speaking, prices rise with money increases.

But it had been observed that prices sometimes fell or rose without any variation in the volume of money, or alternatively remained steady during serious variations in the volume, whilst goods remained constant; it became necessary, therefore, to find out in what respects the old theory was inadequate.

Velocity of Circulation

It will be realised that, if money were destroyed as soon as it is spent, the crude quantity theory would stand the test, and run true to the former expectation; but, as we all know perfectly well, the ten-shilling note which is paid to the gardener may be passed on the next day to the grocer, who may pass it on to the shoemaker, and so on, until that particular note has changed hands perhaps a hundred times in a year, each time acting as the medium for an exchange of goods or services.

Similarly, if you draw a cheque in favour of your tailor, so depleting your bank balance, his is augmented to the same extent, and in turn he may increase the bank balance of his wine merchant by the reduction of his own account. Thus bank money, as a balance on a banking account is termed, may be transferred again and again, just as the ten-shilling note is transferred, with no diminution in its total volume.

We see, therefore, that another factor has entered into the question, and that is the number of times the money is used in a certain period of time. It is obvious that if the ten-shilling note in one year changes hands one hundred times, and in the next, by reason of a boom in trade, or a period of optimism that makes people spend twice as freely, changes hands two hundred times, the same effect has been produced as if there were two ten-shilling notes circulating at the previous year's rate instead of only one.

Realisation of this variability explained the inadequacy of the crude theory and it was thus seen that the velocity with which money—whether coin, notes, or banking balances—changes hands must be taken into consideration. The theory and the relative equation, therefore, had to be re-stated as follows:

$$\text{Prices} = \frac{\text{Quantity of money} \times \text{Velocity}}{\text{Volume of goods}}.$$

The correctness of this theorem granted, it will readily be seen that, if either or both of the two numerator items in our fraction increase, prices will increase accordingly. If the one increases and the other decreases to a similar degree, so cancelling out the variations, no change in prices will occur; if to a dissimilar degree, prices will rise or fall according as the multiplied product increases or decreases. To turn to the denominator, the volume of goods for sale, assuming that the numerator remains constant, any increase must result in a fall in prices and any decrease in a rise. If numerator and denominator

increase or decrease in step with each other no change in prices occurs, but if not in step, then prices will rise or fall according to whether the resultant fraction is greater or less.

The Theory tested

Let us test this quantity theory of money by practical examples. For the sake of simplicity we will suppose that on an island isolated from the world there live ten men, each of whom raises or produces for sale to his fellows 100 units of foodstuffs, goods, or commodities, the total output of the community being, therefore, 1000 units. We will assume the units are each of the same value in the minds of the inhabitants, whether a unit consists of five quarters of wheat, or two pairs of shoes, or ten yards of cloth, and so on.

Let us now assume that the amount of money circulating on the island is £1000, of which each man has one-tenth. As the aggregate purchasing power is £1000, and all the goods go into consumption, it is obvious that the value of each unit is £1, and by their purchases and sales each man at the end of the year will have parted with his £100 and have received £100, which latter is, therefore, the amount of his year's income. It is clear that it must be so, for if some or all the units were priced at more than £1 they could not all go into consumption, and would remain on the hands of the producers. If some were priced at less, the sellers would be short of income or purchasing power for next year; so each must insist upon getting his full £1 per unit, which in fact the buyers are quite able to afford.

Inflation and Deflation

Now let us take the example a step further to illustrate a second case. Suppose that the money has been inflated for some reason or other so that it now amounts to £2000, and is still evenly distributed amongst the ten men. Their purchasing power is now necessarily increased, for each man actually has £200 in hand. It is

obvious that the sellers of the different groups of goods must insist upon receiving £2 per unit of their produce, or they will be short of income next year. All buyers can quite easily afford £2—and at that figure all the goods go into consumption. Hence as the result of doubling the volume of money the price has doubled.

It will be clear to the reader without further detailed demonstration that if, instead, the volume of money by deflation is suddenly reduced to half, or £500, the converse is equally true, and prices will be reduced to 10s. per unit.

Let us, in considering a third example, assume that the amount of money has been reduced to £500, but for some curious reason all decide to insist that their prices shall still remain at £1 per unit. One bright fellow suggests that if the men purchase half the goods in the first six months all the money will have been spent, but as they still have the £500 in money evenly distributed as a result of their sales they can buy the rest of the goods in the second half of the year, and each finishes up with the money that he had at the commencement. Here the money quantity is halved, but the velocity has doubled, for all the money has been utilised twice over in exchange for goods, so the incomes have all been spent and no change in the price has been necessary.

The Goods Volume Factor

Having tested variations in the two component parts of the numerator in the quantity theory fraction, let us turn to the denominator, and test a variation in the quantity of goods. Imagine that by reason of improved methods or new inventions the output of the ten men is suddenly doubled, whilst the money remains at the original £1000 and the velocity at unity as in the first case. The competition of the sellers must now force the price down to half, that is to 10s. per unit, otherwise goods will be left on the sellers' hands; at this price, however, the doubled output can all be purchased by the

community. The result is a doubled standard of living, for everyone has now been able to purchase, and in fact has received, double his previous quantity of goods.

These crude and simple illustrations have been given to assist the reader to appreciate the processes which go on when variations take place, but it will be clear that in an unfettered system of capitalistic enterprise the only controllable variation is that of the quantity of money, and we shall see later how and when this occurs. The velocity is a factor dependent upon the psychological state of the public, whilst the volume of goods, although nominally under the control of the entrepreneur or manufacturer, is usually determined by the fluctuation in the price-levels resulting from variations in the other two factors, and to that extent, therefore, is involuntary.

We can use these examples then to help us to understand the effects of deflation and inflation upon a community. In the second example deflation and inflation successively occurred, but as the money was evenly distributed these processes had no effect upon the standard of living of each individual. The only process which had any effect in this direction was that of a variation in the volume of goods, and here, as the purchasing power remained even, each man shared in the benefit to the same extent. It will now be apparent to the reader that the standard of living of each person in our world, or the volume of goods which falls to his share, will be that proportion of the total output which his annual purchasing power bears to the total purchasing power of the community. Theoretically price matters nothing, for in the perfect world where all production goes into consumption price is merely an expression of the relation between purchasing power and the volume of goods.

Price Variations

The trouble in this imperfect world of ours is that deflations and inflations tend to have seriously disturbing

effects upon the individual distribution of purchasing power. This has been well exemplified in the monetary history of the past twenty years. The early inflation as a legacy of the Great European War was continued, and under the circumstances of our second example prices constantly rose, thus benefiting producers, whose purchasing power increased because their selling prices were constantly progressively greater than had been expected when their costs of production were incurred; those with fixed or only slowly increasing incomes found that their purchasing power bought less and less goods. The producer in a time of ever-rising prices automatically increases his income faster than in normal times, and has only to withhold his goods from the market to secure even larger profits.

In 1920 the monetary authorities called a halt in the inflationary practices, and began a process of deflation, primarily to check the rapid depreciation of money and ultimately to restore the value of the pound sterling to its pre-War level in terms of gold. The resultant gradual fall in prices now acted to the detriment of manufacturers, for their purchasing power, arising from profit, became less in relation to their production costs; conversely the fall acted to the benefit of fixed-income people and wage-earners, whose purchasing power progressively yielded them more goods.

Enough has been said to enable the reader to realise that changes in the volume of money primarily have powerful effects upon the price-level of commodities and these effects may be neutralised or accentuated by a fall or a rise respectively in the velocity of circulation of that money.

Changes in velocity are purely due to mental reactions on the part of holders of money. If, in the real world, you choose to retain part of your income by leaving some of your bank balance unspent or keeping notes in your teapot, because you believe that prices may be cheaper later, your action represents a reduction in 'velocity.'

If, on the contrary, you believe that prices are going to rise, you will spend your money as fast as you acquire it and so assist in increasing 'velocity.' If your action in either direction is a reflection of the general view, the movement has a strong reaction upon the price-level.

We may now pass on to examine briefly the effect of changes in the price-level upon production output.

When an increase in the volume of money takes place which has the effect of raising prices, as occurred during the 1914-18 War inflation, this causes increased profit to accrue to manufacturers as mentioned above. Naturally enough, they begin to increase their output of commodities in order to reap the advantages of such enhanced profits on a greater turnover.

Thus it is true to say that one of the normal results of an increased money volume is, first an increase in prices, with the later corollary of an increase in the output of goods, which however tends to bring down prices again.

Hence we find that when unemployment is rife an agitation takes place in some quarters urging the increase of the money volume by creations on the part of the banks. Theoretically, progressive creations of money should constantly stimulate production until all unemployment is absorbed, at which point fresh creation would only have the effect of raising prices, since no further production can take place, by reason of the full employment of the community. In practice, however, the continual stimulation of production cannot always be counted upon, because of a reduction in velocity which, for various reasons, may ensue and also because increased money creations may not continue to find their way into productive hands. But more will be seen on these points in a later chapter.

The quantity theory of money has been examined sufficiently for us to realise the elementary principles involved and here the reader may stop if he so wishes.

For the benefit of others, however, who care to delve

a little more deeply into the matter, we will proceed to carry the discussion a few stages further, utilising the theory to elucidate more advanced phenomena than those so far described in the simple existence of our island community.

Consumption and Capital Goods

There are two classes of goods which are turned out for sale. One kind comprises 'consumption' goods, which are the things we all eat, wear, and utilise in our enjoyment of everyday life; the other kind includes machinery, land, factory buildings, mines, ships, railways, and others which are collectively described as 'capital' goods, and which are used for the purpose of turning out consumption goods in the same or increasing quantities.

Effects of 'Saving'

These capital goods may be produced in a fully employed community only by saving. Now saving, as we know the term, may be of two kinds, the one beneficial to the community, and the other detrimental. Let us take the latter first, and consider it in relation to our island community. Suppose one or two unsocial members decide not to spend part of their £100 purchasing power, but to hoard it; assume that two men each withhold £20, thus reducing the aggregate effective purchasing power exchanged for goods to £960. As we have seen, the general average price of goods will fall in consequence, since only £960 is available to purchase 1000 units. The result may then be that eight men will next year hold £96 each whilst the two will hold £116 each. If, however, the irreconcilables select the particular product of two of their fellows as those which they will do without, the price of the remaining eight products remains at £1 whilst the two unfortunate producers find themselves short of income by £20 each, for they have had to accept £80 for all their output.

In such a case the new income distribution will be £100 for six men, £80 for the two unfortunates, and £120 for the two unsociables, so upsetting the equilibrium completely, and making things very difficult next year, where nobody knows quite where he stands in relation to the other goods which he will then want. For it is clear that if the two difficult men have hoarded part of their purchasing power this year they may suddenly and irrationally spend it next year, and not necessarily upon the goods of the men whom they have passed by this year.

The position of the two unlucky ones is the same as regards their resultant income if they keep the price up to £1 per unit for the 80 units each they manage to sell, but they will then have 20 units each unsold upon their hands, which goods are probably quite useless to them. This situation is parallel to that in which many producers all over the world have found themselves during the past few years, for in an attempt to bring their purchasing power up to normal they have fruitlessly destroyed more even than their 20 surplus units.

The second method of saving is of a less anti-social kind than the one we have just discussed. One of the ten men has a brain-wave, and he invents a machine which will enable him to turn out double the quantity of the product in which he is interested without the expenditure of any more labour on his part than before. This machine will take him some time to construct, and therefore, in the present year, he will be able to produce say 70 units only instead of his customary output. The result at the end of the year will be that if the shortage in goods is spread over the whole community there will be £1000 available to purchase 970 units, and the price will rise accordingly, but the nine men will finish the year with over £103 each, whilst the tenth will have £72 only, plus the expectation of more than catching up by the aid of his machine next year. If the demand for the goods of the inventive man is, however,

strong because the community must have them, then £900 probably will be available to buy the other 900 units which will then sell for £1 each, whilst £100 will be necessary to buy the 70 units of his particular product, raising the price to something over £1, 8s. per unit, and the odd man, therefore, will still have his £100 at the year end.

Savings and Prices

In either case he will additionally have a machine capable of saving him the expenditure of energy in turning out his product. He has become a capitalist, and the amount of his capital is whatever his machine may be worth. He may use his machine next year to turn out his usual 100 units and then bask in the sun for six months in the year, thus becoming partly a gentleman of leisure. If the demand for his product is elastic he may on the contrary decide to be energetic and turn out 200 units, selling them all at 10s. per unit, thus giving the benefit of his invention to his fellow-islanders.

On the other hand, he may sell them all for what they will fetch in the old manner, which might result in lowering the price for the island's total products to the value of £0.909 per unit, which is the equivalent of £1000 purchasing 1100 units. At the end of the year his purchasing power would then be £182, whilst that of his neighbours would be a little less than £91 each. He might even insist that he should have the full benefit of his inventive brain, and hold out for the highest price that he can persuade his fellows to pay, in which case the disparity in incomes would be even more pronounced.

Communal Saving

There is yet another method which might have been adopted by the community. The nine men may have subscribed funds to form a company for the purpose of financing the inventor whilst he made his machine.

In such a case he could sell his 70 units at the normal price of £1, and the remaining £30 purchasing power spread evenly over the nine would then be utilised by them to subscribe the capital for the new company in equal shares. The capital being paid out to the inventor, as remuneration for his services in making the machine, brings up his total income to £100. The whole community will then own the machine jointly, for we may be sure that such a fair-minded body of men would not fail to allot free to the inventor, for his services, a tenth share in the company, as well as the wage of £30. Henceforward, however, the inventor is the salaried servant of the community, for he will use the communal machine in his daily work and must look to the company for his income, unless indeed he hires the machine from the company and gives the benefit of the increased output to the community in the form of his rent. But here the matter becomes further complicated by the kaleidoscopic number of variations in the treatment of the case possible, which will only fog the issue for the reader, so we will refrain from pursuing the question any deeper.

It is not the purpose of this chapter to discuss anything other than economic abstractions; no opinion, therefore, will be expressed as to whether the 10s. price, the £0.909, the even higher one, or the joint stock company, is ethically correct and desirable. Probably the nine would applaud the first-named figure if the inventor kept his machine for himself, or in the other alternative they might even consider it well to assist the genius by doing without still more of his former productive output whilst he applied his time and energy to making other machines which would increase productivity in their own particular fields as well as in his own trade. Their action in 'saving' in the sense of doing without his product temporarily and subscribing the money to the company would then reap a rich reward in the increase of the general standard of living.

This series of analogies is naturally far from being a precise reproduction of everyday occurrences, and is not even an exact presentation of the figures and results which would obtain in the island community, since certain factors are omitted for the sake of simplicity and clearness. The method may, however, be found helpful in aiding the reader to gain a firmer grasp of the interactions of money, production, and prices. And the analogies can be utilised by the student to elucidate further problems as he or she may consider interesting or necessary.

Chapter VIII

MONETARY SYSTEMS: BIMETALLISM AND THE GOLD STANDARD

UP to the reign of Edward III, in the fourteenth century, the only coinage in England consisted of silver, and the silver penny was the money of account. This unit, however, was found of too high a value for many domestic transactions, since at that time commodities were generally very cheap as compared with silver. A petition to the King begged him therefore to issue half-pennies and farthings since, it recited, beer was selling at three gallons a penny and a pennyworth was too large a quantity to buy at one time; also, the petition argued, the penny was too much to give in alms and in church. The King responded by issuing token coins of the denominations desired.

When, however, he wished to finance Continental commitments, during the Hundred Years' War, the silver pennies were found to be of insufficient value for large-scale transactions, and the King therefore caused to be coined the first gold piece known in this country, the gold noble, which was reckoned at that time as of the worth of eighty silver pennies; its weight was actually about 10 per cent. above that of our modern sovereign.

Gresham's Law

Henceforward we had concurrently in our currency silver and gold coins, although the former were considered the principal media of exchange, the gold being of secondary importance since it was used only in non-domestic transactions. It was natural that the authorities should endeavour to fix the relationship between these two coins, just as to-day the relationship

of the shilling is fixed at one-twentieth of the pound. But it was discovered that first the one metal and then the other would tend to disappear from circulation, just as, at a later date, it was also observed that if the silver and gold coinage were subject to deterioration caused through abrasion, or in more reprehensible ways, any full-weight coins of either sort immediately disappeared from circulation, leaving the worn, clipped, or sweated ones to fulfil the purposes of currency.

In Elizabeth's reign Sir Thomas Gresham was consulted as to the reason for this phenomenon, which was then very rife, and he enunciated that economic law which since has always been known as Gresham's Law; this declares that 'bad money drives good money out of circulation.' He explained that, when domestic goods could equally be purchased with full-weight and short-weight coins, people naturally hoarded the good ones and paid with the short-weights. Moreover, goldsmiths sorted out the full-weight coins, and melted them down, exporting them in payment of debts or giving them in exchange for imported merchandise. The foreigner, not being interested in our domestic currency, would take the coins only on the basis of the worth of their actual metallic contents. A less number of full-weight coins, therefore, being required to pay for a given quantity of goods from abroad, the good currency rapidly disappeared overseas.

In the case of gold and silver currency circulating at fixed equivalents, if one became overvalued in terms of the other, the coins of the other metal would be kept back, melted down, and exported in the same manner as the good coins mentioned above. If, for instance, the weight-for-weight ratio of gold to silver was fixed by law at 1 to 12, and gold appreciated in value until the market ratio became 1 to 13, it obviously became profitable to pay all internal accounts in silver and abstract the gold, which could then be melted down and sold as bullion at the higher market rate, with a profit

of $8\frac{1}{2}$ per cent. The reasons for these variations in market value of silver or gold were usually that a new mine or source of the one or the other had been discovered, and the increased quantities thus thrown on to the market depressed the value of the metal so enhanced in quantity.

Bimetallism ,

At the end of the seventeenth century the relationship of gold to silver was fixed at 1 to $15\frac{1}{2}$, but the usual fluctuations in real value caused the alternate disappearance of silver or of gold, and different ratios were decreed from time to time in order to obviate these occurrences.

This state of having two metals bonded together at an artificially fixed rate, both being legal tender, is termed bimetallism. The theory of its exponents is that the currency is built upon a wider basis than can be provided by gold alone and that fluctuations in the value of either metal are likely to cancel one another out, provided that international agreement can be arrived at to prevent bullion merchants effecting operations in the two metals which result, as we have seen, in the withdrawal from the currency of one or the other metal.

The Latin Union

France was always very attached to the double standard, and in 1865 there was formed the Latin Union, consisting of France, Italy, Belgium, and Switzerland, all of whom adhered to the system of bimetallism. These countries mutually agreed that their gold twenty-franc pieces, together with the Italian twenty-lire piece, should be of the same weight and fineness, and that the silver five-franc or lire pieces should be similar coins. Moreover, it was arranged that the coins should be legal tender for exchange in any country of the Union, although arrangements were

made for clearance should large aggregations of the coins of a member be found in another's territory.

Bimetallism was practised for the greater part of the nineteenth century, but the action of Great Britain and Germany in de-monetising their large silver coinages, and that of the United States in discontinuing the minting of silver, threw such large quantities of the white metal on to the bullion market that it fell in value to an extent which made it impossible for the Union to maintain the ratio. Consequently, rather than revalue the silver, they adhered to the fiction of bimetallism, but in practice limited the coinage of the five-franc pieces and thus, to all intents and purposes, became gold monometallic.

Britain adopts the Gold Standard

To return to our own country, in the period prior to the formation of the Latin Union the Government became tired of the situation and, deciding in 1816 to abandon the attempt to link silver and gold together, concentrated upon the latter metal as the sole monetary standard. The Coinage Act of that year, and subsequent legislation, decreed that the pound sterling should be definitely related to gold at the rate of £3, 17s. 10½d. per standard ounce. Now standard gold is eleven-twelfths fine gold and one-twelfth alloy, so that the equivalent of fine or pure gold is just under £4, 5s. per ounce.

The silver coinage was definitely relegated to an inferior position, for it became token money having an intrinsic value below that of its nominal value. In other words, the coins are similar to small-value bank notes except that they are stamped on a rather more valuable medium than paper. Moreover, they are not legal tender for larger sums than £2. In an identical sense, copper coins are token money, and they are not legal tender in excess of 1s.

The law directed that any person should have the right to take gold to the Mint and receive in return

sovereigns at the decreed rate, free of brassage, that is, free of the cost of minting, which in fact the State bears. As may easily be calculated, the weight of the sovereign was thus 123·27447 grains of standard gold, of which 113·0016 was pure gold. In practice, nobody took gold direct to the Mint for coinage, but went to the Bank of England where, under the Bank Charter Act of 1844, the public was entitled to demand money or notes at the rate of £3, 17s. 9d. per standard ounce. It was worth while to give up the difference of 1½d. per ounce to avoid the loss of interest involved in waiting for the Mint to coin the gold, for that institution required some little time to convert gold into sovereigns—certainly more than the twelve days on which 1½d. represents the interest at 5 per cent.

It has been shown in Chapter III how the Bank Act of 1844 laid upon the Bank the obligation not only to purchase gold at £3, 17s. 9d. per ounce but also to deliver out gold in exchange for notes at the rate of £3, 17s. 10½d. per ounce should any person so demand it. So long then as this Act remained inviolate the note was rigidly linked to gold coin or bullion at this fixed rate. As a holder of bank money could always demand notes, bank money was equally tied to gold and at the same rate. Therefore, whatever was the value of gold, so was the value of money in general.

The Variable Value of Gold

This point is one which sometimes presents difficulties to the inquirer who is unable to conceive the meaning of value except in terms of money. It is understandable that the price of tin may vary—say, from £200 to £250 per ton—but, argues such a person, if the price of gold is fixed at £3, 17s. 10½d. then gold is always worth that amount. The difficulty occurs because it is overlooked that gold itself may vary on its own account, just as wheat or tin or rubber may vary by reason of an over-production or a shortage in relation to the needs of the

users. Precisely in the same way, the value of gold may fall in relation to other commodities, which themselves may be stable, through a new goldfield having been discovered which causes production above current real needs for monetary purposes, for arts, crafts, or for manufacture. Since, however, the Gold Standard laws decree that one ounce of gold, whether of high, low, or medium real value, must always be exchangeable for £3, 17s. 10½d., it results that money itself must follow the real value of gold.

Let us see how this works out. Assume that over a period the average price of a group of commodities has been x shillings and suddenly a new and prolific goldfield is discovered where the nuggets are to be had merely for picking up. It is clear that gold so easily won will depress the value of the metal, and the growers of wheat, raisers of beef, and manufacturers of the rest of the group of commodities will be inclined to exchange less of their products against an ounce of gold, or, what is the same thing, against the sum of £3, 17s. 10½d. in money.

In other words, they will raise their selling prices although the real value of their product has not altered. The average price of the group will therefore now be $x + y$ shillings, y depending upon the quantity of gold being thrown upon the market. To put it in another way, if the commodity producers are measuring their values by gold which depreciates in value, then they will want more gold in exchange for their goods. But, since gold and money are irrevocably linked together, the sellers will require more money. They do not, of course, reason it out in this way, but that is the result of the forces which, unseen and unrealised by them, govern their actions. Exactly how these forces operate will be explained in a few moments.

This variability is the chief drawback of the Gold Standard; instead of being an absolute measure of value, it is as though one had a yardstick which was liable to expand or contract enormously between 50 inches of

actual length in the heat of summer and 20 inches in the cold of winter, so that the apparent measurement of a non-expandible object would be small in the former season and large in the latter. The 'winters' of gold occurred when new goldfields, such as those discovered in the Yukon, in California, Australia, or in South Africa, were pouring out their first spate of products; the 'summer' when these goldfields had become exhausted. The 'autumn' or normal occurred when a steady stream of gold production was taking place from mines which were moderately easy to work without yielding inordinate profit to the producers, and such output corresponded to the growth of the world's monetary and commercial needs.

It has been authoritatively calculated that, under the Gold Standard, the growth of the population and the average increase in its standard of living requires a 3 per cent. annual increase of monetary gold in order to keep prices reasonably steady.

If then, after the world's commercial needs are satisfied, there remains sufficient to permit this 3 per cent. compound increase annually in monetary gold, fairly distributed amongst the great banking systems of the world, these authorities consider the question of price stability to be solved, so far as monetary quantities can ensure it. If at any period gold output is greater than monetary needs require, there is a tendency for prices of commodities to rise; if the output is less the opposite tendency occurs.

The Working of the Gold Standard

Let us consider how a Gold Standard actually worked in practice. In the chapter on the Bank of England we saw that the authorities took care to preserve a constant relationship between the reserve of notes in the Banking Department and the volume of deposits. If a quantity of gold were tendered for sale, which under the 1844 Act the Bank was compelled to buy, the account

of the seller, generally a bullion broker, was credited with the value. This increased the deposits in the Banking Department whilst the Reserve was also enlarged to the same extent, for the purchased gold was handed over to the Issue Department by the Banking Department in exchange for its equivalent in notes. Reference to the Bank of Albion examples in Chapter III will show that the proportion had become in consequence higher than necessary, and the Bank therefore could increase the amount of credit, either by making loans or buying securities, thus increasing the deposits still further without affecting the reserve until the proportion was reduced to the percentage considered adequate.

If the Bank considered such an increase of credit undesirable, it took steps which resulted in gold flowing abroad, so reducing the amount of the Reserve.

Under the old gold standards in the various countries any accession of monetary gold automatically resulted in an increase in the volume of their money in just the same way as shown above when the bullion broker received credit on his account at the Bank of England in respect of the gold he sold to it. It is a fact, then, that if a new source of gold were discovered, the gold tended to spread throughout the Gold Standard countries and thus became the base of increased volumes of money all over the world.

As we have seen in our study of the quantity theory, the immediate tendency was for a general rise in prices to take place. This in turn encouraged manufacturers to increase their production everywhere, with the result that a boom and a period of prosperity ensued. The inflation in such circumstances was of course a very mild affair, since the new additions to credit were only small in proportion to the existing volumes, but they were enough to give the requisite fillip to trade to ensure the continuance of the boom. When the gold sources became exhausted, and accessions of credit were no longer continuing, prices became stationary and then

tended to fall, with the result that depressions followed. So the trade cycles went on through the course of the nineteenth century, largely due to variations in the world's gold production.

It was mentioned above that if the Bank of England considered further credit creations in Great Britain undesirable it took action to facilitate exports of the surplus gold, and the reasons impelling such a decision were concerned with keeping prices here in step with general world prices, which was always a very important consideration in monetary economics. The expedient adopted was the very simple one of reducing the Bank Rate, and as the other banks here follow this lead, the general interest-level in the country tended to fall. If by chance the banks did not respond, the Bank had methods of making its rate effective, which was essential if the desired object was to be achieved.

International Funds and Gold

In pre-1914 days, and in the halcyon times of the freely operating Gold Standard, London was a very large depository of funds belonging to foreign banks and international finance. When interest rates on this side were higher than in a foreign centre it became profitable for financiers to send their funds to London in preference to keeping them in the other country. If, however, the action of the Bank of England reduced the interest yields here, the foreign funds immediately became repatriated, so sensitive were they to interest conditions, which of course are important when such vast sums are concerned. Now the act of selling sterling in large bulk in order to achieve the object of repatriation has such an influence upon the foreign exchanges that less and less of the foreign currency is obtainable for each £1, until ultimately the rate must drop to a point where it is cheaper for the financier to withdraw gold from the Bank of England by the presentation of notes, and pay the charges of shipping and insurance in order to bring

the gold home. He would do this in the knowledge that he would be able to obtain his own currency there, be it dollars, francs, guilders, or other, in exchange for the gold at the price fixed under the Gold Standard laws in his own country. In this way then was the surplus gold disposed of by the Bank of England.

The Gold Points

When the position was the reverse and the Bank was somewhat short in the Reserve, owing, for example, to an abnormal excess of imports over exports which was causing an unwelcome drainage of gold abroad to pay for the excess, the Bank of England would be forced to contract credit in order to maintain the proportion of the Reserve. If it considered contraction inadvisable, and decided to avoid it, the Bank Rate was raised, so making it profitable for financiers to send their floating funds to London. Their demands for sterling in such an event would cause them to pay more of their home currency to buy £1 sterling and thus raise the exchanges in favour of London, so removing the profitability of sending gold out of England. In fact, whenever the need for gold was sufficiently acute in London, the interest rate was raised high enough to make the financier's demand for sterling so strong that the exchanges rose to the point where gold flowed in. This would occur for precisely the same reasons that in the opposite circumstances caused gold to flow out; that is, because it became cheaper to obtain gold in the foreign centre and to ship it here rather than to buy high-priced exchange. Incidentally, it may be mentioned that the rates at which it became cheaper to ship gold were called respectively the low (or outward) and the high (or inward) gold point.

Gold Movements and Prices

There was another interesting effect consequent upon the outflow and inflow of gold. As we have seen, the

result of an outflow was a contraction in the currency issue with a consequent fall in the Bank's reserve, which loss in point of fact was principally reflected in a reduction of the 'other banks' deposits' in the Bank's figures. This again tended to make the banks contract their advances and loans to customers with a consequent fall in the purchasing power of the nation, since bank credit balances have to be utilised to repay the loans. Naturally, following the quantity theory, it is to be expected that prices would fall in this country and so make it a good centre for a foreigner to buy in and a bad one in which to sell. The purchases of sterling to pay for these cheaply purchased goods sent up the exchanges, and so tended to cause imports of gold which counteracted the effect of the earlier loss of gold.

In the case of an undue inflow of gold precisely the converse happened. The mounting issues of credit against the imports of gold tended to raise prices in this country and thus made it profitable for foreigners to sell their goods here and unprofitable to buy from us. The consequent demand for foreign currencies against sales of the sterling received for their goods depressed the rates, and gold would flow out, thus righting the matter of the former surplus.

The Mechanism of a Gold Standard

We see, therefore, that if the Gold Standard authorities in all countries played the game according to the 'rules,' and allowed gold movements to have their due effect upon the internal money quantity position, we had an automatic regulator which ensured that no country should have gold stocks in excess of its actual needs and that prices everywhere should be in a state of equilibrium. In pre-1914 times the game generally was played according to the rules by the leading nations and all was well. The Gold Standard was consequently an almost perfect mechanism, and had it not been for the fatal defect of the variation in the intrinsic value of gold

itself making the 'yardstick' a variable measure, a better one could not be imagined.

We, in those days, as the nation with the greatest surplus of exports over imports, took care not to insist upon an abnormal inflow of gold to balance the two and so place an undue strain upon the mechanism which would have deranged the general credit situation by an inflation here and deflation abroad. Nor did we take in gold and hoard it, thus refusing to work according to the rules by declining to issue the appropriate corollary of credit. Actually we made foreign loans in respect of our excess, that is to say, we did not exact payment for these surplus goods but sent them as loans to the importing or other countries, and thus the normally ensuing gold inflow to balance the export surplus was obviated.

Gold Standard and Freedom of Trade

Here then is the secret of a proper working of the Gold Standard and herein lies the cause of the abject failure of post-War efforts to rehabilitate the gold standards of the several nations. It is essential that reasonable freedom of trade movements shall be possible in order that the maximum corrective effect of variations in price-levels shall have full play in regulating the gold reserves in each country. If one country insists upon maintaining a large export trade, either for the reason of reducing production costs or for political reasons, then it must allow the internal price-level to move to such a point as will not only permit but actually facilitate the import of a corresponding volume of materials, whether raw or finished. Above all, the political embargo upon, or hindrances to, imports, whilst exports are encouraged, cannot be allowed to operate, unless the country practising the system is prepared to make foreign loans and in this manner take the strain from the monetary and exchange mechanism which otherwise is bound to collapse.

In this country, with our former free-trade economy and the willingness of our investors to make foreign loans, we admirably fulfilled these conditions in pre-European War times. The change, however, in political sentiment, here no less than abroad, from international good will to narrow sectionalism, from a standpoint which sees the situation as a whole to one which permits group interests to dominate the national economy, has done even worse things than to break down the international monetary system. It has helped in the destruction of the feeling of international brotherhood which might have been built up after that war, fostering instead the ideas of ever more and more economic self-sufficiency and national isolation.

But all this is a subject apart from the scope of this book; it is mentioned with the view of indicating how a grasp of monetary economics may be utilised to lift argument from the narrow realm of particularism into that of broad and overriding principles.

Chapter IX

WAR AND THE GOLD STANDARD

WHEN the Great European War broke out in 1914 all the countries involved immediately abrogated their gold standard laws, so absolving their banks of issue from the necessity of paying out the metal against notes. Everywhere the export of gold was prohibited except for strictly controlled purposes and, of course, for payment of imported war material. Naturally it became a matter of immediate national urgency to conserve all gold supplies, for these would later be increasingly required to purchase munitions and supplies from neutrals, when home resources were feeling the strain, or were actually fully utilised. Gold then might make all the difference between ultimate victory and defeat.

The immediate result of these departures from the gold standards was that the exchanges, torn from their anchorages of the gold parities, drifted at the mercy of the relative pulls between the supply of, and the demand for, foreign exchange. At the immediate outset, American interests having large commitments to meet in London, the dollar-sterling exchange was forced up to the unimagined height of \$6.50 and more to the £1, as against the par of exchange of \$4.86 $\frac{2}{3}$ or the inward gold point of 4.89. Later, however, the tide swung the other way and the enormous purchases in America for war and other purposes, not only by Great Britain but by the Allied countries, gave rise to overwhelming demands for dollars, which caused the rate gradually to fall. The British Government then 'pegged' the exchange at 4.76 $\frac{1}{2}$, at which point it remained during the War years. Now this state of 'pegged' exchange rates can only be effected in a country which has an overwhelmingly adverse balance of trade, if supplies of dollar exchange are provided sufficient to keep the ratio

at the desired figure. If gold is not available, as in fact it cannot be in large enough quantities unless the backing of the currency is to be denuded, the only methods of obtaining the necessary dollars are by exporting more goods, raising loans, or selling securities. The first method is clearly impossible in war-time when the national effort is already too fully exerted to be able to turn out such an additional volume of goods, even assuming that the neutral country is willing to accept them. The second method is of limited availability even with our Government's responsibility for the loans, and in actual fact it was not until America came into the conflict, and her Government raised vast public loans for home and allied purposes, that the method supplanted the third course, which by then was almost at the point of exhaustion.

The British investor during the previous century had lent millions upon millions to America for the development of her railways, mines, public utilities, and many other purposes. But with the outbreak of war, the predilection of the British public for a mixed and well-spread holding of securities had to be overcome and made subject to the national necessity. All American and even many Canadian holdings were mobilised and taken over by the British Government, which first pledged them to New York financial houses to cover dollar loans, and later, when it became evident that the War was going to be a long-drawn-out affair, sold them outright to the American interests for cash to repay the loans so raised.

The Abrogated Standard and Inflation

The departure from the Gold Standard removed the automatic check upon inflation which under that system comes into operation when gold begins to leave the country and credit is thereby reduced consequent upon the diminution of the gold backing. The course, therefore, was set for the inevitable inflation of the

currency, which in fact at once began to arise by reason of the loans raised by the Government in excess of the actual 'self-abstinence' savings of the people. Such loans were floated as 'Ways and Means' advances at the Bank of England, by the purchase of Treasury Bills on the part of the financial interests and by bank purchases of government obligations, or by bank loans to individuals upon the security of their investments in the War Loans which they bought with the borrowed money. In this manner, the practicalities of which will be discussed in another chapter, enormous increases in the volume of money took place. These created a gradually increasing state of inflation, despite being concurrent with a greatly increased output of war goods, because the loans were not extinguished at the time the goods went into consumption as is the case with ordinary domestic production. Thus the volume of money was continually increasing whilst the goods available for purchase by the public did not increase but rather, on the contrary, decreased.

The Spiral of Rising Prices

When the War came to an end people began to desire the things that they perforce had denied themselves during the previous four years. The small stocks of goods available were purchased with avidity and the psychology of the period caused the velocity of the money turnover steadily to increase, thus accentuating the effect of the already enormously swollen volume. Prices, therefore, in accordance with the quantity theory of money, began rapidly to rise. Manufacturers and producers, stimulated by these rising price-levels, borrowed more and more money from the banks in order to finance increased production of their commodities, which they sold at ever higher and higher prices, the additional purchasing power thus created serving to accentuate still further the extraordinary demand; people hurriedly bought to-day to avoid paying more

dearly to-morrow. The analogy of a dog chasing its own tail is the only parallel for a situation where rising prices caused more demand for bank credit and mounting credit caused prices to rise yet again.

Deflation and Falling Prices

So the wheel revolved ever faster until in April 1920 wholesale prices had risen on the average to nearly 325 per cent. of the pre-War level. The authorities, becoming alarmed at the vicious spiral, decided that a halt must be called and accordingly took measures to stop the constant accretion of credit. Not merely, however, did they stop fresh issues, but they took steps which actually and suddenly reduced the existing volume. The nature of these steps will be described in a later chapter.

Probably for want of experience, for nothing in history provided comparable circumstances, the brake was applied with far too violent effect, with the result that the whole mechanism, being subjected to an unexampled strain, suddenly went to pieces causing such a breakdown that confidence in every quarter disappeared almost instantly. Prices tumbled down headlong, manufacturers throwing goods on to a constantly falling market in order to cut losses already heavy; trade buyers holding off from fear and sensing that in any case they would buy the cheaper by waiting; the public to some extent satiated and only needing the slight discouragement of the turn to stop purchasing. Producers no longer embarked upon fresh manufactures except for goods under contract with middlemen who had ordered far more than they really required in the hope of getting at least a partial delivery during the riot of prosperity, but who now were compelled to default where they were unable to persuade the manufacturers to cancel or defer their contracts. The stoppage of production threw large numbers of workers out of employment, reducing the purchasing power of the

public still further and ever decreasing the velocity of money, until average wholesale prices, as shown by the Index numbers, had fallen by the end of the year from the peak of 325 to 230 (1914=100). Roughly speaking, this meant that a group of goods which in March 1920 could have been sold wholesale at £1 fetched only about 14s. in December. And this was far from being the worst, for a year later they would have fetched less than 10s. and during 1922 only about 9s. 7d. Thus prices had dropped to less than half the figures reached at the height of the boom, and it is easy to see that manufacturers who had commenced the production of goods on the basis of costs ruling prior to April 1920, which only came to completion after that date, were faced with selling prices far below the actual cost of manufacture unless they had made sales for forward delivery, in which case their buyers instead were subject to the disastrous loss.

It will be realised that the two numerator factors in the quantity theory of money fractions discussed in Chapter VII had decreased, particularly the velocity of money, whilst the denominator or quantity of goods was still increasing, for merchandise in process of manufacture had to be completed and in many trades it is cheaper for the entrepreneur to continue to turn out unordered goods at a loss than to close down his factory. Furthermore, as the public declined to buy, stocks could not be reduced for a long period. Small wonder, therefore, that the price-level fell so precipitously when all three factors swung so violently to that end.

The German and Austrian Inflation Dêbâcle

Although at such a cost in widespread distress, the authorities had however achieved their aim in checking the inflation of the pound, which could, of course, have taken the course of the Austrian Krone or the German Mark. Those responsible in these two countries, either

through faulty economic beliefs or through sheer inertia (for it is difficult to see how they really could have held the opinion attributed to them that their note issues were not inflationary), did not utilise the experience of our deflationary processes but allowed their currencies to depreciate unchecked until they became almost valueless. At all events, the Mark was stabilised by devaluing the currency at the rate of one continental billion (1,000,000²) old Marks to one new Mark; the Krone was devalued at the comparatively handsome figure of 10,000 old Kronen for one Schilling, as the new unit was called. Both figures were disastrous to the holders of money or fixed-interest securities. In comparable circumstances here, by way of illustration, a person with a former fortune of, say, £100,000 invested in War Loan, in mortgages, or cash in the bank, would possess only £10 (Austria) or one-forty-thousandth of a penny ($\frac{1}{40,000}d.$) (Germany) after stabilisation. In both countries, therefore, the retired person living upon the interest from such securities was financially annihilated.

The only people who came off without great hurt were those dealing in commodities, land, buildings, and the like, for the value of these rose commensurately with the depreciation of the currency. Thus, for instance, if the price of a loaf of bread to-day were M.100,000 (£5000 at par) and the currency had depreciated by half during the course of the day (this degree of depreciation is not fiction, but actually happened many times), the price at breakfast-time next morning would be M.200,000. Everybody hastened to turn his wages into goods before the prices, hourly rising in geometrical progression, had swept away a large proportion of their purchasing power; earners of weekly wages or monthly salaries clamoured for more frequent pay-days in order to obtain food at the prices current when the stuff was consumed and the money earned. Still more indicative of the actual situation, but less serious, was the position of a restaurant diner who, finding that he wanted a second

bottle of wine, was asked to pay M.1,250,000 instead of M.1,000,000, the price of the earlier one, the restaurateur having heard in the interim the latest quotation for the dollar. In those days in Germany the American gold dollar was the standard of comparison; with every rise in the exchange quotation, so was the price of this and that commodity increased. Thus, if 'No. 20' was reckoned by the proprietor as \$2.00 the bottle and the dollar-mark exchange at the moment was 500,000, then the diner would be charged M.1,000,000; when the rate rose to 625,000 the price became M.1,250,000.

Devaluated Currencies

Russia had, of course, trodden the path of inflation, to the point of rendering the old Rouble worthless, very early after she ceased to participate in the hostilities. Italy, Belgium, and France suffered from the prevalent disease, but all three checked the rot before the position had gone too far and became unmanageable.

All the various countries mentioned stabilised their currencies in course of time, some by the creation of a new unit, whilst others checked the riot of depreciation before it got out of control and fixed the values of their money at a lower level in relation to gold than formerly. Germany, Russia, and Austria were examples of the first-mentioned class, for they allowed their old currencies to depreciate to the point of worthlessness and then commenced new currencies on the ruins of the old. Even though these in some cases were called by their former names, yet they had no other relation to the earlier units; the old bank balances, bank notes, and obligations alike were virtually extinguished. Thus, an old Mark, a Rouble, or a Krone conferred no right of purchasing power after the change, but they were exchangeable into the new units at such an infinitesimal ratio as to be negligible for any practical purpose.

The other group, however, simply revalued their currencies by declaring them to be the equivalents of

a smaller gold content than formerly. France, for instance, has had several essays in devaluation. In pre-European War times the franc was legally the equivalent of 322 milligrammes of gold .900 fine. After the inflation had threatened to get out of hand, M. Poincaré adopted rigorous methods to bring down the degree of inflation considerably and, after holding the position at a stable figure for some time, gave legal sanction to the new order by enacting in June 1928 that henceforward the franc was of the worth of 65.5 milligrammes of gold .900 fine. Some eight years later another inflationary adventure had made necessary a further devaluation, and this time the franc was given a gold content on a kind of sliding scale. It could be declared worth 49 milligrammes at the maximum and 43 milligrammes minimum, as the authorities considered expedient from time to time.

In June 1937, however, these limits had to be swept away although the gold and foreign exchange at the Bank of France were revalued at the 43-milligrammes figure. Further devaluation has since taken place, although not to any specific new gold content of the franc, until in 1939 it stood at about one-twelfth of the pre-European War franc in terms of gold, albeit the real value of the franc had not depreciated so heavily as the gold value. Rentiers (a term for those who live on their investments in fixed-interest government bonds and similar securities) suffered severe hardship in consequence of these successive depreciations.

In similar manner the Belgian franc was worth only about one-tenth of its pre-War gold value and the Italian lire less than one-sixth.

Britain re-establishes the Gold Standard

The authorities in this country, however, were determined to raise the value of the pound to its pre-War gold value and to re-attain the Gold Standard. The policy at the time was called 'making the pound look

the dollar in the face,' for, of course, up to then America had remained throughout on her pre-1914 Gold Standard. Strenuous efforts were made to deflate our currency in order to raise its value until in 1925 the Chancellor of the Exchequer felt able to announce that once again the Gold Standard was operative. Although there was no intention of rehabilitating the former gold coinage, and certain minor restrictions made it a little less easy to obtain bar gold or bullion in exchange for notes from the Bank of England, yet the 1844 Act governed our money anew after a suspension of eleven years.

For a time all went well and no difficulty was experienced in maintaining our position, circumstances having favoured us. For one thing, in 1927 there was a boom in trade which gave us a good export surplus and consequently no demand upon our gold stocks threatened to upset the equilibrium of the Gold Standard. In 1929, however, the situation changed and the settlements of the questions of German Reparations and of our debt to America caused a steady flow of gold to France and America, the ultimate beneficiaries of these settlements. By their tariffs they largely prevented goods from being sent in payment and the hiatus therefore had to be made up by gold shipments, since this was the only import they would take without hindrance.

It was soon evident that the strain of maintaining the Gold Standard was now imposing a heavy burden on British industry and the competition of devalued-currency countries in the world's export markets was too great. The constant need to defend our gold reserves progressively required deflationary measures, with the result that money became ever more valuable, thus causing prices to fall, with consequent distress to our manufacturers. The average price of goods steadily declined in this country from the time we went back to the Gold Standard, until in 1931 it had dropped to two-thirds of its 1925 level. Unfortunately, America

and France did not use their increasing gold to create more and more credit, a proceeding which would have allowed prices to rise in their countries, so making them profitable centres in which we could have sold our exports, and so restored the gold position, as in the pre-War days. Instead, they 'sterilised' the gold, burying it in their bank vaults, and for all the use they made of it, in the monetary sense of the old pre-War Gold Standard days, it might just as well have stayed in the South African holes whence it originally came.

Forced off Gold

And so matters progressed with ever-increasing difficulty owing to the deflationary fall in prices mentioned above, until in 1931 the climax in disaster came. For some time many European countries, whose laws permitted funds in Gold Standard countries to be considered as the equivalent of gold, had maintained large balances in London. France in particular had left here a large proportion of the huge sums paid over to her by the Germans in respect of reparations, which sums the latter had in fact borrowed from us. Suddenly, our foreign creditors took fright and an overwhelming rush of gold withdrawals took place. All efforts to stem the tide were fruitless and in September 1931 we were forced once again to depart from the Gold Standard.

Managed Currency

Since then we have had a 'managed' currency—that is to say, a monetary system which is consciously controlled by the Bank of England in consultation with the Treasury, according to its estimate of the volume required in the best interests of the nation. As will be remembered, the position under a Gold Standard, freely functioning everywhere, was to a large degree automatic and required little or no independent control.

The immediate result of our leaving the Gold Standard in 1931 was a small increase in wholesale prices, which

on the average rose about 5 per cent. After that year prices rose slightly and steadily in spite of occasional short periods of recession. This rise was just sufficient to benefit manufacturers without being unduly onerous to consumers, and it continued until 1937, when something like an incipient boom occurred, for a rise of 13 per cent. over the 1936 wholesale prices showed that the velocity of money had increased considerably, since no more than a 3 per cent. increase in bank deposits had taken place.

It is evident that the authorities felt matters were getting a little out of hand for they turned the screw very slightly in a deflationary direction, with the result that a severe fall of $12\frac{1}{2}$ per cent. in prices ensued during the following twelve months, a circumstance reflected in the dull condition of trade during 1938-39. More will be said later on this question of the control of a managed currency and the difficulties of delicately handling the problem.

Index Numbers

In the course of this book the terms 'price-level,' 'average prices,' 'index numbers' have often occurred, and it is therefore perhaps appropriate here to discuss them briefly, for they are all-important in the understanding of monetary economics.

Their meanings can be best illustrated by concrete examples. If last month it was possible to purchase a two-pound loaf of bread for $4d.$ which to-day costs $4\frac{1}{2}d.$, the price of bread has appreciated by one-eighth, or by $12\frac{1}{2}$ per cent. One might express the occurrence by saying that, taking last month's price as 100, to-day's price is $112\frac{1}{2}$. Now this increase might be attributable to several circumstances. It might be that the cost of wheat or flour or bakers' labour had risen, or that the value of money had fallen. If the case of bread were an isolated circumstance, one would naturally attribute it either to a rise in cost of wheat or to the fact that the

Bakers' Union had enforced a rise in bakers' wages, either of which circumstances could be verified by direct inquiry. If, however, such an inquiry revealed nothing, and it was noticed that, concurrently with bread, the price of coal, timber, sugar, cottons, potatoes, steel, and other commodities had also risen, the observer would realise the unlikelihood of influences inherent in each separate commodity being the operative causes of the rises. He would realise that the phenomena must have a common origin and one external to the conditions of production of the various articles. Such a common origin might consist of variation in the quantity of money in circulation or in the velocity with which it changes hands, as has been mentioned earlier.

Such changes would not necessarily have precisely the same quantitative influence upon the price movement of each article and it is desirable, therefore, to reduce the question to one of the average variation of the cost of a long list of representative commodities. This makes a general comparison easier and more accurate when considering short-period movements or those spread over a long time. If we can say that commodity prices have risen by 10 per cent. during a half-year and can connect this with known movements in the money quantity, the velocity of circulation, or the volume of goods on offer for sale during the same period, we are within measurable distance of linking up cause with effect.

'Weighting'

A difficulty will be immediately apparent if bare figures are taken into account in arriving at average prices. For example, if two articles are considered, the one, sugar, which has risen 15 per cent. and the other, coal, which has risen only 5 per cent. it would scarcely be reasonable to say that on the average they had risen

$\frac{15 + 5}{2}$, or 10 per cent., for it would imply that both

articles were of equal value in the human scale of needs. If, however, coal is considered to be of three times the importance of sugar, taking into account the relative values of each that go into annual consumption, the fair expression of the average price increase of the two articles would be: $\frac{15 + (5 \times 3)}{4}$, or $7\frac{1}{2}$ per cent.

In this way then the various commodities are 'weighted' and an average of a large group is calculated, taking each article as of value 100 in the standard year of comparison. The year used for this purpose varies, sometimes being taken as 1913 and at others as 1867-77, 1927, 1930, or other years according to the authority compiling the 'index numbers of wholesale prices' as the results are called.

There are several different indices in this country; the principal ones are compiled respectively by the Board of Trade, the *Economist* and the *Statist* newspapers, on the basis of wholesale prices. Additionally there is one called the 'Cost of Living' index which is based on certain retail prices and which is also compiled by the Board of Trade. The wholesale indices vary from each other very considerably owing to the different lists of commodities utilised and also by reason of differing ideas as to the degree of weighting called for in the individual items. But the trends are usually similar in character and the choice of index is a matter of individual taste according to the purpose of the user.

The movements of these index figures are of great service to the economist, and taken over a long period of years give a clear idea of the general movements of prices, although not necessarily of values.

Although so far as our money is concerned we are now free of the direct interference of gold in our commodity price-levels, yet it is of interest to consider the price of gold itself as an academic question.

The United States, having experienced a slump of an intensity not even matched by the hard times through

which we have passed, decided upon an inflationary policy which in time led to the devaluation of the dollar in terms of gold. As one of the provisions of his 'New Deal,' President Roosevelt initiated legislation whereby he was given power to reduce the gold content of the dollar up to a maximum of 50 per cent. as he thought fit. During 1933 it was reduced and by January 1934 instead of gold being valued at \$20.67 per fine ounce, as formerly, it was revalued at \$35. Thus a depreciation of the dollar in terms of gold of 40.94 per cent. had taken place. America was then and still is on a Gold Standard, but at this much lower level of 59.1 per cent. of the former gold content.

The Tripartite Agreement

In 1936 a tripartite agreement was concluded between America, France, and ourselves, whereby all parties agreed to keep in mutual consultation with the object of maintaining their currencies in step with each other and with the intention of avoiding competitive deflationary actions designed to assist the export trade of the one country against the others: Belgium, Holland, and Switzerland later also expressed their adherence to this pact.

Some thinkers have felt that since the dollar was tied to gold at \$35 per ounce, and sterling and francs were tied to the dollar through this agreement, then the two latter currencies were indirectly back on gold via the dollar.

There are two answers to this argument. The first is that the agreement was elastic and did not prevent reasonable adjustment, as is shown by the fact that the pound sterling was allowed to fall in terms of dollars by over 15 per cent. during the next year or two, whilst France by mutual consent made drastic departures from the agreement, in favour of the franc. The second point is that the area of the world which was grouped around sterling was relatively so large that prices in that

area must be dominant and that therefore American prices were more influenced by sterling prices than vice versa. Consequently world prices of commodities tended to conform to managed-currency conditions rather than to a small portion of the monetary gold taken by America. A further point is that the gold producers, by their action in selective mining, instinctively took the course calculated to keep gold prices steady in terms of commodities. Whilst they continued to utilise as much of the low-grade ore as possible, in order to maintain the lives of their mines to the maximum extent compatible with earning steady profits, they were automatically keeping the price of gold steady in relation to other general commodity prices.

Fixing the Price of Gold in London

It is of interest to consider how the sterling price of gold was fixed from 1934 to 1939. It was not purely a question of supply and demand; if it were, the fluctuations would have been considerable since the monetary demand was comparatively small and the purchase of the metal for hoarding purposes spasmodic. Instead of the free market which would exist were all countries off a Gold Standard, the sterling price of gold was kept fairly constant by reason of the link between the dollar and gold, the one fluctuating quantity being the dollar-sterling exchange. Thus, if a gold producer was offered a smaller sterling price than he thought reasonable he would ship his gold to New York, convert it into dollars at \$35 for the ounce, less certain small assay and allied charges, selling the resultant dollars for sterling at the current exchange.

It will be seen therefore that the sterling price of gold varied directly with the sterling value of the dollar, allowing for the small additional cost in freight and insurance and the charges on the other side involved in sending the gold to New York. Within this margin, the

price of gold per ounce in London was calculated by dividing \$35 by the number of dollars which exchanged for £1. For example, if the exchange rate was $4.68\frac{1}{2}$ the theoretical price of gold was: $\frac{35.00}{4.68\frac{1}{2}} = \text{£}7, 9s. 5d.$ per ounce.

The freight, insurance, handling, and assay charges roughly amounted to 1s. per ounce and the London actual price was therefore £7, 8s. 5d. per ounce. If the offers of gold were large the seller might have had to pay a premium of $\frac{1}{2}d.$ or 1d. per ounce, which however would not deter him, since he got his money at once instead of having to wait until the gold arrived in New York.

The fact that gold in 1939 stood at nearly £7, 10s. per ounce as compared with the old figure of £4, 5s. would appear to indicate that a very serious depreciation had taken place in the paper pound and that the latter was worth only some 57 per cent. of the pre-1914 War pound; in the Press jargon popular a year or two before, the pound was worth only 11s. 4d. (that is, 57 per cent. of 20s.). Actually, such an idea is completely erroneous. Were it correct one would confidently expect the average prices of commodities to stand at:

$$\frac{150s.}{85s.} \times 100 = 176$$

taking 100 as the average prices of 1913, the last year of the old normal Gold Standard. Instead, the comparable wholesale index number was in May 1939 something less than 110, which shows fairly conclusively that gold was not of the same value as it was in 1913. Assuming that the average real values of commodities were not greatly different from those of 1914, it would seem that, since their average price was about 10 per cent. higher, gold itself must have appreciated in value by 76 per cent. minus 10 per cent., that is about 66 per cent. This would illustrate the justice of remarks made in the previous chapter as to the variability of gold as a standard of value. The view as to the appreciation in

gold is supported by the fact, as mentioned earlier, that we know the gold-producing companies were mining the metal from very low-grade ores, which made it much more expensive to extract, and that since their profits were not inordinate the resultant gold must be worth more in terms of other commodities; in other words, gold had appreciated.

Ever since the Control fixed the dollar exchange in September 1939 the Bank of England has valued its gold at 168s. The price calculated in the manner given above would be 173s. 6*d.*, but the high cost of insurance whilst in transit to America possibly has some connection with the smaller valuation adopted.

It is a matter of conjecture whether we shall ever see the Gold Standard again in operation in this country. Although there is a strong body of thought which prefers gold with its manifest drawback of variability, yet there is another school which abhors this standard. Which will prevail is doubtful, but with the bitter experience of 1925 to 1931 in memory he would be a bold prophet who foresees the commercial community readily acquiescing in a resumption of the domination of gold in Great Britain, whatever may happen elsewhere.

Chapter X

THE TECHNIQUE OF BANK ACCOUNTANCY

It is essential to a proper understanding of the nature of money that we should have a clear idea of book-keeping. This is the more necessary since all money other than bank notes and coin is purely and solely represented by book-keeping entries. Please do not immediately decide to skip this chapter as a boresome or dull penance; properly grasped, there is nothing more fascinating than accountancy. Was it not Charles Lamb who wrote: 'He [John Tipp] thought an accountant the greatest character in the world and himself the greatest accountant in it.' And again: 'To the genuine accountant the difference of proceeds is as nothing. The fractional farthing is as dear to his heart as the thousands which stand before it.'

Do not be misled by the cynic who said figures could prove anything. On the contrary, figures cannot lie though the mode of presentation may be designed to mislead the unwary.

The first essential to be grasped is that any concern possessing an adequate system of books has assets and liabilities which, on paper at least, must be identical in amount. It is true that by reason of culpability, carelessness, rashness, or sheer bad luck the assets may ultimately prove to be of less worth than the figures at which they appear on our books, and something will then have to be done about it; exactly what will emerge later.

Double-entry book-keeping is by no means merely an accountant's fantasy or a convention, but is the natural corollary of a clear expression of the facts. To prove the contention let us illustrate by means of a series of transactions as they might occur in practice.

The Foundation of a New Bank

We will commence upon the assumption that several of us propose to start a new banking concern. We shall first ascertain that the capital with which we intend to start will be forthcoming. Cheques will reach us from the various contributors till we have received, say, a sum totalling £100,000, at which figure we have fixed our capital. If we are sufficiently important, hopeful, or confident, as the case may be, we open an account in the name of our bank with the Bank of England, into which we pay our cheques. Clearly, then, in our books we have to express the fact that we have a credit account which represents a liability of £100,000 to the shareholders under the heading of 'Capital' and a debit account representing an asset consisting of 'Funds with the Bank of England' of the same amount. Our auditors, coming into our embryo bank at this moment, would be able to prove these two accounts firstly by a check on the value of the share certificates issued and by a certificate from the Bank of England that we have that amount lodged with them.

It is as well to emphasise here that when someone pays in money, we give him *credit* for the amount; if someone draws or otherwise receives money from us, we *debit* him. If at any given moment the transactions result in a final credit balance, we have a *liability* to that person; if a final debit balance, we have an *asset* which we expect to be able to collect in due time.

Accounts are opened

Next let us assume that our reputation is so high that friends and well-wishers decide to open accounts with us. If cheques to the value of £20,000 and cash and notes to the value of £6000 are received by us, obviously the several current accounts in the names of the new customers will be credited with an aggregate sum of £26,000, this representing another liability of the bank.

On the other hand the cheques paid into our Bank of England account will raise the relative debit balance or asset on our books to £120,000. The cash we shall put into our till and, in order to keep a record of the stock of money, we shall debit a 'Cash in hand account' to register the asset of £6000.

By this time our customers will have issued cheques, or orders to pay, upon us. Some will be drawn perhaps in favour of other of our customers, some in favour of non-customers, some indeed for cash. Assume the figures are £1000, £2000, and £500 respectively. The first cheques will make no difference to our bank's general position, for the debits to the drawers of the cheques, causing a reduction of their credit balance, will be exactly offset by an increase in the credit balances of the payees. As to the second group, the bankers of the payees will present the cheques to us for payment and we shall settle their claim by means of our own order, which will result in a reduction of our balance with the Bank of England. The entries in our books will show debits to our customers' accounts of £2000 and a credit to the 'Cash at the Bank of England account,' thus reducing both by £2000. In the case of those customers who demand cash and notes, their accounts will be reduced by £500 and a credit to 'Cash in hand account' will denote that the till money has also been reduced to the same extent.

A Discount Transaction

But here comes a customer who wishes us to discount a three months' bill of exchange for £1000. After deciding that the acceptor of the bill may be expected to be able to honour his obligation to pay when the due date arrives, and that even if he does not our customer himself is able to support the liability, we agree to the proposed transaction. The current rate of interest on such a bill is quoted and the discount, as it is commonly called, will be calculated on the intervening period up

to maturity; suppose this discount to be £6. Our customer's account will be credited with the net sum of £994, a new account in our books headed 'Profit and Loss' (or a sub-account facilitating analysis of our profits) with £6. The full amount of the bill will be debited to an account designated 'Bills Discounted' and the paper will be placed in portfolio awaiting the arrival of its due date or until we deal with it otherwise. The aggregate of such bills in portfolio will be equal to the debit balance representing the total of these assets.

A Loan is Granted

The next customer, maybe, is a manufacturer. He, it appears, is desirous of purchasing a quantity of raw material, and, pending the completion and sale of the finished article, requires finance. We, being satisfied as to the credit-worthiness of the customer either by reason of the proffered security or perhaps of his character and wealth, are agreeable to make the required loan of £5000. A loan account is opened in his name and £5000 is debited thereto, simultaneously with his current account being credited with the amount.

It will not have escaped notice that these last two transactions—the discounting and loan operations—have so far had no effect whatever outside the books of the bank. This is of particular importance when we come to discuss the all-essential question of money creation in the next chapter.

Money Market and Investment Transactions

Two other transactions, which shall be the last we need use to illustrate our accountancy system and to complete a microcosm of our banking operations, are acts of investment. We have come to the conclusion that our balance lying idle, from an interest-earning point of view, at the Bank of England is larger than is necessary for our needs. With the intention of keeping

some of our funds only a little less removed from the complete and immediate availability that is inherent in a balance at the Bank of England (liquidity is the technical phrase) we decide to lend funds to the so-called 'Money Market,' thereby earning a little interest.

Again, with the desire to earn higher remuneration still, we decide also to purchase some Government bonds. The considerations that guide our choice are discussed in another chapter. The liquidity of this asset will of course be a little less than that of the market loan, but our acumen is such that we have made a wise disposition in regard to the relative proportions, the selection, and the purchase price, so no undue risk is run.

We have, then, decided to lend to the market £50,000 and to invest £30,000 in Government bonds. Unless these transactions take place with some of our own customers the cheques we draw in payment obviously will involve a reduction in our Bank of England balance to the tune of £80,000. The entries in our books will be (a) to credit the £80,000 to 'Funds at the Bank of England,' and (b) to pass a debit of £50,000 to an account entitled 'Money at Call or Short Notice' and £30,000 to another headed 'Investments in British Government Securities.'

Whilst the immediate effect of these two transactions has been to deplete our funds with the Bank of England, it is necessary, for reasons that will appear hereafter, to stress the fact that the operations have had not the slightest effect of depleting our customers' balances on current account.

If the reader has been interested enough to figure out the result of this series of transactions he will find that the Bank has arrived at a state of affairs represented by the following balance sheet:

LIABILITIES (credit balances)			ASSETS (debit balances)		
Capital	.	£100,000	Cash in Hand	.	£5,500
Customers' Current			Funds at the Bank of		
Accounts	.	29,494	England	.	38,000
Profit and Loss			Money at Call or Short		
Account	.	6	Notice	.	50,000
			Bills discounted	.	1,000
			Investments in British		
			Government Securities	.	30,000
			Loans to Customers	.	5,000
		<u>£129,500</u>			<u>£129,500</u>

And *mirabile dictu* the books of our bank balance to Elia's 'fractional farthing,' although in truth nowadays the banks recognise no smaller book-keeping unit than the penny.

Chapter XI

THE CONTROL OF THE PRICE-LEVEL

It is generally agreed and indeed, for the ordinary person, beyond the realms of argument, that the first essential of money should be stability of value, but it is not so easy to decide what exactly ought to be involved in the term stability, since values necessarily can only be discussed in terms of something else. Thus, for instance, we might decide that money must always be stable in terms of bread, so that a stable shilling will always buy, say, five pounds of bread, whether to-day, next week, or in the next century. But, since we know that bread fluctuates with the price of wheat, which in turn fluctuates according to the quantity of the annual harvest in relation to the requirements of mankind, we see that it is not possible to confer stability upon money by linking it to bread or wheat, for whilst it may be constant in such terms, it will certainly be inconstant in terms of some other medium or media which fluctuate in real value at different periods of time. If, for example, we have a bumper harvest whilst during the same year the murrain has carried away a large portion of the cattle, the prices of beef in terms of our 'bread money' will show a large rise which will be out of all proportion even to the losses in stock.

We have already seen that the fetish of tying money to gold which has prevailed for so long has been equally unsuccessful in giving stability, and for precisely similar reasons.

What then is to be done to acquire this greatly to be desired stability? The modern answer is to take a large compound group of commodities and link money to these, thereafter taking such action as will ensure that the average total money value of the group remains

at a constant level. If this is attained we have acquired stability in the sense that £1 in money will always purchase the same quantity of the goods which compose the group.

But a difficulty immediately presents itself in deciding upon the nature of the group to be selected. Whilst one set of commodities might suit a certain class of persons by keeping prices steady in the things in which they are interested, it might be totally unsuited to another class. For instance, the interests of the poorer people would require the commodity group to be made up almost entirely from certain foodstuffs, cottons, wools, and textiles, which are notoriously subject to wide fluctuations in value due to weather and other conditions affecting agricultural output. Such a list, however, would be quite unsuitable to the wealthy classes since only a small percentage of their incomes is spent on foodstuffs and clothing. Again, a manufacturer, in the interests of his business, would call for a group in which his own particular commodity is heavily 'weighted' and this would vary from trade to trade. The agriculturists would favour a very different selection from that of their urban friends and even from that of other sections of their own industry.

The Components of the Price Index

The choice of the commodities to be used to form the 'index' must, therefore, be somewhat of the nature of the 'greatest common denominator' and a compromise between the conflicting interests of various classes of the community. Even so, difficulties inevitably arise. For instance, it is easy to see that, of a large group of commodities, the agricultural components might conceivably fall in value whilst the metals might rise, the one so exactly setting off the other as to result in equilibrium of the combined group. In such a case, the farmers would suffer by falling income from the sales of their products whilst the working classes would benefit

thereby; the miners and mineowners, as well as royalty owners, would do well out of the rise in metals whilst the users, such as the building and engineering trades, would suffer unless they could pass on the increased costs, in which case the machinery users, possibly including the then doubly unfortunate agriculturist, would be penalised.

These difficulties are, however, unavoidable and indeed insuperable without the aid of compromise, but they are no worse than those which obtain under the Gold Standard, for prices based on the latter bear no relation whatever to the particular needs of any class, whereas a commodity standard may conceivably do so.

The authorities, then, in this country normally endeavour to keep prices on an even keel by reference to the index numbers of wholesale prices. We do not know which index they use, but since the Board of Trade index is quoted in the 'Statistical Summary' issued by the Bank of England month by month, one may assume that their actions are based upon the movements indicated by that index.

The Various Indices

An illustration of the difficulty of group selection mentioned above is provided by the wide variation exhibited by different indices, for they show how values may vary as a result of the choice of commodities and systems of 'weighting.' The Board of Trade, the *Economist* and the *Statist*, taking 1913 as 100, show the averages for 1938 as 121, 98, and 108 respectively; the variation of over 23 per cent. between the highest and the lowest is a serious difference in indicated values when the figure is used for monetary control. The directions of the movements invariably agree, which is helpful so far as it goes, although the degree differs, so ultimately giving rise to the different levels. The final choice of the index which shall be as nearly perfect as possible however can only be an evolutionary develop-

ment resulting from experience over a long period of years.

Natural Cheapening and the Price Index

There is, however, another factor to be taken into consideration which concerns the natural cheapening of a commodity by improved methods of production. If, for instance, a machine is invented which doubles the output of, say, artificial silk, the logical result would be that the price of the article falls by half and the manufacturer hopes that consumption ultimately will be more than doubled. The immediate effect upon the index number is a fall in accordance with the drop in the price of the article. If, however, the general price-level is subsequently so adjusted that the fall in prices is taken up and spread over the whole group, the benefit of the cheaper prices which should have ensued to the consuming public is to an extent nullified and manufacturers get an undue benefit.

To make the point clear, let us suppose that such an invention, by reducing the price of artificial silk by half, so affects the wholesale price-index number that it falls from its level of, say, 105 to 103. This means that in future 103 shillings will buy precisely the same quantities of the group of goods that formerly required 105 shillings; the 2 shillings saved may be utilised to purchase more of everything and so the standard of living rises by nearly 2 per cent. as a result of the invention. If, however, the authorities do not realise the reason for the fall, and in the ordinary course of their duties in money management so adjust matters that the index number is restored to 105, the consumer derives no benefit from the invention unless and until his income is increased, which, however, is not in question at the moment. The benefit instead is conferred upon producers in general (not the artificial silk manufacturer in particular) for, taking them in the aggregate, they receive 105 shillings for what they can sell at 103 shillings on the old basis of

profit. It is a moot point as to whether it is practicable to attain a system of monetary management which permits index numbers to fall by the natural cheapening of any one or more components with a resultant drop in the general price-level. Naturally, in the event of research proving it to be possible, any increase in prices, such as might for instance result from the working out of the national coal seams, with enhancement in the value of the mineral, would have to be reflected per contra by allowing the appropriate rise in the general price-level to stand without adjustment in the value of money.

Linking Money to Commodities

We must now consider the means by which money is linked to a group of commodities. It is obviously impossible to ordain that the Bank of England shall purchase, at the prescribed price, loads of the components of the price index in the proportions established by the system of 'weighting,' which it must warehouse in colossal quantities until such time as a note or money holder may demand quantities of the group in exchange for his money. The methods adapted to a Gold Standard are totally impossible with the bulky and often perishable goods which comprise a price-index list. The ludicrous conception of a top-hatted member of the money market driving up to the Bank with a pantech-nicon containing some hundredweights of pig-iron, lead, tin, and rubber, a ton of coal, a few dozen four-pound loaves, besides bushels of potatoes, sides of beef, a pig or two, and a host of other commodities against which he requires money to be issued, is one only fit for the pages of *Punch*.

Nor is it enough merely for an Act of Parliament to declare that a specific quantity of the amalgam shall be worth £1 to-day, next week, and for ever, for if natural causes intervene which make the commodities more plentiful or scarcer, as the case may be, the price of them

inevitably will be less or more than the £1; on the other hand, if money quantities grow or diminish, the price then will be more or less than the £1.

In a country which allows freedom of the individual to produce what goods he will and in what quantities he pleases, according to his prevision or guess that such production will yield him a profit, the only factor which can be centrally controlled or guided is the money quantity; here therefore we perceive the key to solve the problem of linking money to commodities so that a given quantity of the latter shall be of the constant value of £1.

If the authorities find that the price index shows signs of falling they may decide that the volume of money must be increased, so providing additional purchasing power available to the public for buying goods; if the index shows a tendency to rise they may decide that a decrease is indicated, with reduced purchasing power. Were the variations in money directly effective, in strict proportions to its volume, the problem of price control would be perfectly simple, but, as we saw when considering the quantity theory, there is the additional complication of variable velocity of spending. It is quite possible therefore that an increase in the volume at one time may have no effect whatever upon the price-level, because the holders have failed to use the additional money for commodity purchases; and at another it may have an unexpectedly violent effect in raising the price-level by reason of a different sentiment as regards spending on goods. The velocity has slowed down in the first case and accelerated in the second.

Difficulties of Monetary Control

It is this uncertainty as to the degree of sensitivity which makes the management of money still more difficult. If the public is slow in responding to an increase in money volume by reason of its placing the money on deposit account or in otherwise holding off

from purchasing, which is another way of saying that the velocity has slowed down, the only means available is still to continue increasing the money quantities. If at last the delayed response takes place it is apt to be more pronounced than is desirable, because the money volume has been increased more than should normally have been necessary to restore the falling price index and it may become advisable once again to contract the volume. Such frequent variations, however, are not very desirable for obvious reasons, and the authorities perhaps may feel that variations due to the psychological factor of velocity must be left to take care of themselves. There is the added reason that as change in money volume is slow in making its effect felt, and the lag therefore is somewhat pronounced, an exact control of the price-level is not easily attainable. It is not surprising that the price-level shows such a varied outline since money management commenced in 1931, after the departure from the Gold Standard. When it is considered what constant disturbances have arisen through international difficulties it would be astonishing were it otherwise; in times of peaceful development it is probable that a graph depicting the course of prices would have exhibited a fairly even course.

In order still further to illustrate the problems involved in money control let us consider a suggestion that has found acceptance in some economist quarters. It has actually been seriously proposed that the most desirable system would be one in which prices rise annually to a very slight degree, on the grounds that manufactures would thereby be constantly stimulated, with a resultant rise in the standard of living. But dwell for a moment on the position of a young man who takes out an endowment life policy with the object of providing a house and other amenities when he retires in forty years' time and finds that an annual price rise of one per cent. has reduced the value of his policy to about two-thirds of his expectation. It is true that his premiums will have

been paid in progressively less valuable money and his position so differs from that of a man who took out a policy in the last decade or two of the nineteenth century which matured in 1921, for it was then only worth one-third of the money in which his premiums had been paid. This possibility is illustrated by the constant suggestions by insurance companies that their older policy holders should reconsider the amount of their insurances in relation to the decreased value of money as compared with pre-War times. However, the problem is illuminating in that it shows the complexity of the money problem.

There is the other factor of the volume of goods production which we have not yet considered in this chapter in connection with the price-level. As we know, whenever a rise in prices occurs, manufacturers are stimulated to increase their output, with the result that prices tend to fall proportionately to such increase. It will be perceived that another difficulty arises here, for the increased production occurs only some time after the increased volume of money has raised prices, and another lag is set up in addition to the one we have already noted. This provides yet another disturbing element in the effectiveness of money control.

If the authorities increase the money volume and, after some hesitation, the price-level ceases to fall, and indeed it suddenly and unexpectedly rises, production is thereby stimulated and sows its own seeds for a later fall. But the stimulation of production will not be manifested for some months and, by then, other action over the money volume may have been taken by the authorities to check the rise in prices which had already become apparent. Then when the increased production is made manifest the volume of money will not be adequate to sustain even the low prices reached, and a further fall is experienced.

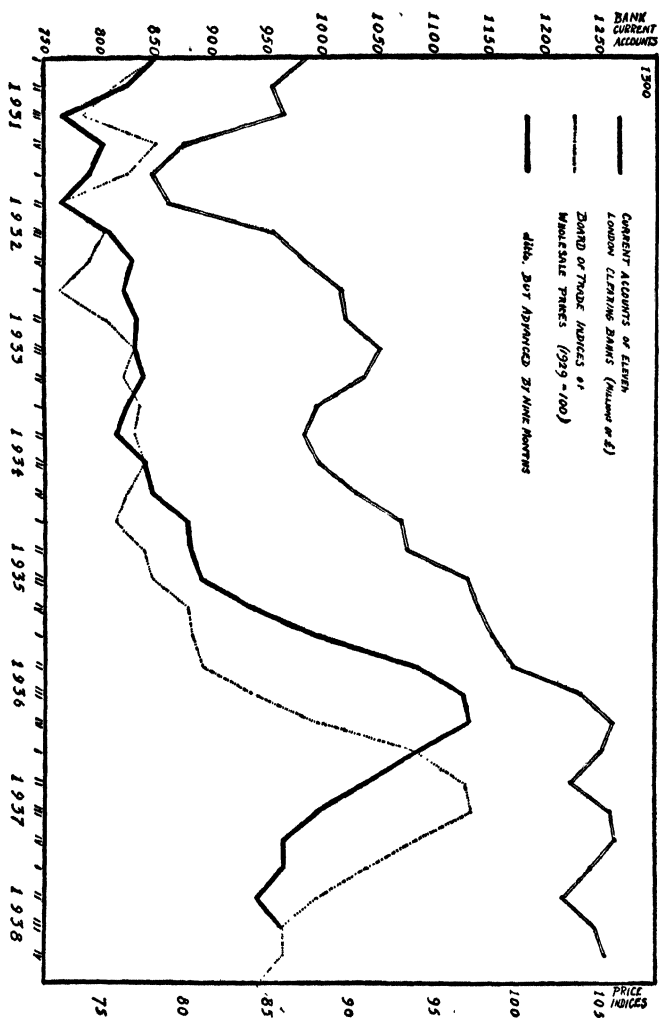
All this goes to show the extreme difficulty of the problem of managed currency, and it is small wonder

that many prefer to stick to the admittedly unsatisfactory Gold Standard which requires no such technical and complicated inquiry and research. But the importance of stable money is so great that no difficulties should be allowed to stand in the way of devising the perfect system.

The Volume of Money and Prices since 1931

It will be of interest to consider the relationship between bank deposits and the price-level between the beginning of 1931 and the end of 1938, and to this end a graph is shown, which plots the curves (a) of the effective volume of money and (b) of the movement of prices. The first is built up from the quarterly figures of the current accounts of the eleven London clearing banks and the figures are the average weekly balances during the months of (1) February, (2) May, (3) August, (4) November in each year, reduced however to current accounts alone by means of the percentage figures published by the Bank of England. These months have been chosen because they are less affected by temporary derangements due to half-yearly balance-sheet exigencies. The full figure of the current accounts and deposits would be undesirable for the purposes of this graph since the former have varied during the period from 49 to 55 per cent. of the whole. The second curve shows the Board of Trade indices of wholesale prices on the basis of 1929 = 100. These figures are the average index prices for the months following those used in the deposit figures. The basis of 1929 is different from that used elsewhere in this chapter, but the curve would be identical were the 1913 = 100 basis used. In point of fact, if 36 per cent. is added to the 1929 indices we arrive at the figures applicable to the 1913 basis and the relation between the two is naturally constant.

We first must observe that a very large increase of money on the current accounts with the banks has taken place since 1931, amounting at the maximum to no less



than £420 millions. This increase has been a steady progression up to 1937 except for a recession of a little over £70 millions for a year, in 1933-34. A large part of the increases in 1932 and 1936 was due to fugitive money, mainly from France. Since such funds usually lie dormant upon the accounts they are inoperative for purposes of spending in purchases of goods, and therefore have no effect upon the price-level. If it were possible to eliminate this money from the graph it would probably be found that the bulge of 1932-33 would be considerably flattened and the gradient during 1935 and 1936 would be much more gradual, sharply rising however in 1938-39, for, by then, much of the foreign money had been repatriated and its place taken by money created by bank loans to the Government to provide for the rearmament expenditure; this is, of course, very definitely money spent on the purchase of goods and material. In these circumstances, it is difficult to account for the fall in prices of nearly 13 per cent. during 1938, or, rather, to account for the slowing down of the velocity, for the indices of ordinary industrial production do not show any increase, but rather a decrease in the output of commodities. It may be that large quantities of goods which had been stimulated by the sharp rise in prices of 1936-37 had not gone into consumption and the money-volume recessions of 1937 and 1938 therefore had an exaggerated result. If so, this illustrates the remarks made a little earlier on the production factor.

It will be observed however that the curves of current-account bank money and index prices roughly follow each other in main outline, but there appears to be a lag of about nine months on the part of the latter, which indicates that changes in money volume do not make their influence felt for at least that period. The price-curve therefore has been re-plotted by advancing it three quarters; there are indications that if it were advanced by yet another quarter it would correlate

more accurately to the money-volume curve, particularly from 1931 to 1933, immediately after the departure from the Gold Standard.

The diagram however furnishes a very interesting confirmation of the general effect of money volume upon prices, whilst it clearly shows the difficulty of exact control. It is to be hoped that research on the part of those in a position to obtain more accurate data than is available to the non-official investigator will throw much-needed light upon many points that are to some extent obscure at present.

Chapter XII

THE MANAGEMENT OF MONEY

BEFORE proceeding to discuss the methods by which money is managed we must first consider how bank money is created at all, for this question is the focal point of any understanding of monetary economics.

We have seen that when the goldsmith-bankers received gold or silver upon deposit from their customers they issued receipts which developed into notes, and which were utilised by the holders as money when they passed them on to creditors in payment of debts. In a similar manner the banker also gave credit in account to customers against deposits of gold and silver money, which deposits the latter disposed of at will by their orders (cheques) addressed to the banker. Here the goldsmith held an asset in hard money whilst he had a liability to his customer in respect of the current-account balance.

In both these cases the notes and the bank money did not constitute an addition to money but were simply a substitution for gold and silver coinage which thus became immobilised, taking on a static form from which it did not revert to the status of money until it was surrendered to the presenter of notes, or exchanged back for cheques drawn against a credit balance, the equivalent notes or balance being thereupon cancelled.

Creations of Bank-note Credit

When a customer of a goldsmith however asked for a loan, which was granted, we saw that the accommodation began to be paid out in the form of notes which the goldsmith created, both in the literal and the financial sense, and which had no gold or silver backing; instead the banker, on the one hand, had a book asset in that his customer owed him the amount of the loan whilst,

on the other, he had a liability to some person in respect of the circulating notes which had been issued to the customer in respect of the loan and which the latter had paid away to his suppliers or workpeople. Here was the early instance in this country of the issue of paper credit without full metallic backing. The goldsmith would continue to make such loans so long as the percentage of the gold and silver in his possession to the notes circulating did not fall below the minimum which he considered to be a safe figure as backing. As we have already seen, the Bank of England transacted business on precisely the same lines but on a greatly increased scale, and in fact the notes began to be turned out by the printing press instead of by hand.

When the joint stock banks however started business along with the existing private banks in London, neither of which had the privilege of note issue, they commenced to grant loans to customers by giving them credit on current or drawing account, which the latter disposed of by issuing their cheques thereagainst.

It will be seen from the foregoing that whenever a note or a credit balance was created by the Bank of England, or any other bank, against a deposit of gold or silver coin, no addition whatever to the total volume of money took place, but immediately a loan was granted an equivalent addition to the total volume of money was the outcome. Reference again to the Bank of Albion examples in Chapter III will demonstrate that the bank's books reflect the position by showing on the assets side 'gold and silver coin' or 'loans to customers,' whilst the liabilities of a bank having issue rights will show the figures of the 'notes issued' or 'customers' current accounts' or, in the case of non-issuing banks, simply 'customers' current accounts.'

As we saw in Chapter X, when a customer draws a cheque upon his credit balance it may be paid in to the credit of another person's account with the same bank, in which case no alteration in the total amount of

the bank's liability takes place—only a change in the ownership of the money from that of the drawer of the cheque to that of the payee. Again, the payee may be a customer with a credit balance at another bank and, in that event, the reduction in the 'current accounts' with the first bank will be exactly offset by an increase in those with the second bank; in either case, however, no change has taken place in the aggregate volume of the nation's money. If, however, the payee of the cheque has previously borrowed from his banker and utilises the money to reduce or pay off his loan, either directly or by transfer from his temporarily enhanced current account, it is clear that the reduction in the drawer's credit balance is not in the event matched by an increase in that of the payee; a reduction in the total volume of money has therefore occurred as a result of the repayment of a loan. The position is accurately summed up, therefore, when we declare that the granting of loans creates bank money and that the repayment of loans extinguishes bank money.

Creations of Bank Money

In order to make the processes quite clear, let us imagine a bank which already has current accounts upon its books for, say, £500,000 standing in the names of, and to the credit of, its customers. If its cash amounts to £75,000 (the figure is, of course, entirely hypothetical and for the sake of clearness much exaggerated) the proportion of cash to liabilities is 15 per cent. If, however, the bank, conformably with general practice, considers 10 per cent. to be sufficient, it can comfortably see its deposits increased by a further £250,000, without additions to its cash, and still have the proportion which it considers safe to meet all likely demands for withdrawals in cash. If, therefore, at this time manufacturing customers should come along and ask for loans which aggregate this sum, proffering adequate security, the bank can quite well acquiesce.

If it does so, the result will be that the customers are severally debited in loan accounts whilst their current accounts are credited with the same amounts.

If the bank were to take out a balance sheet at that psychological moment it would reveal that the assets side has been increased by £250,000 in respect of 'loans to customers,' whilst the liabilities on current accounts have similarly increased to the total figure of £750,000; cash still remains at £75,000, and the ratio is now 10 per cent.

It is evident then that by this action the bank has created deposits (or bank-credit money) to an additional extent of £250,000 by a few strokes of the pen. This additional money now lying to the credit of the customers is available for them to spend, and they will disburse it by cheques in favour of their suppliers of raw materials, their staff, and others.

Ignoring for the present the fact that some of the recipients may keep their accounts at different banks, and conveniently assuming that they all deal with the bank under consideration, it is clear that another balance sheet taken out by the bank after the disbursements have been effected will show exactly the same state of affairs as regards total current accounts, loans, and cash as the earlier one. An analysis however would show that the credit balances are now spread over a large number of current accounts, instead of being held by the borrowers as was the case when the previous balance sheet was taken out.

Cancellations of Bank Money

Now let us imagine that at a later date the borrowers have sold the goods which they manufactured with the aid of the loans granted to them, and their current accounts have thereby been enhanced by the value of their sales; these incomings will probably have amounted to £250,000, plus the profits. Naturally these customers will not wish to continue paying interest to the bank

on their loans whilst they have money lying idle in current accounts, so they ask the bank to cancel their loans by transferring the equivalent funds from their current accounts. The bank's balance sheet after these transfers have been effected will show a reduction in loans and current accounts alike by the aggregate sums of £250,000. Unless the cash held has been varied by reason of transactions unconnected with those we have described, the way is again clear for the bank to start the process all over again and to make fresh loans to the same or other customers.

For the sake of simplicity, a single cycle of creation and cancellation has here been described, but it is hardly necessary to say that similar ones are constantly taking place amongst all the banks, and that some of the payees of the cheques disbursed will use the funds to repay a loan or overdraft which they themselves have previously contracted. The point to remember is that creations and cancellations are continually occurring and the aggregate volume of bank money at any given moment depends upon whether creations have been in excess of cancellations, or *vice versa*.

Creations by means of Bank Advances and Discounts

Loans in account are not the only form in which accommodation may be given by the banks with consequential creations of money. We saw that the bank founded by us in Chapter X discounted bills for a customer. In essence this is no different from a loan, so far as the customer is concerned, except that the interest is collected by the bank at the inception of the transaction instead of at a later date; other immaterial variances are that the bank will collect repayment from a third party and not from the customer and that the asset is described as 'bills discounted' instead of 'loans to customers.' But an addition to the total volume of money has taken place just the same; the customer receives the bulk of the creation to the credit of his

current account whilst the remainder, representing the small amount of discount, will be credited to the bank's 'revenue' account to be disposed of sooner or later, along with numerous other similar items, by transfer to its fixed-deposit customers for interest, to its staff for salaries, and to its shareholders for dividends.

Money Market Creations

Proceeding with this question, and using our 'Chapter X' bank transactions to illustrate, we may omit the loan to the manufacturer, since similar affairs have just been discussed, and pass on to the money-market loan. Here, it may be thought, is a transaction different in character from those preceding it, since the motive for it is to utilise excess funds which we have in our account with the Bank of England. But actually it is no different, for the effect is to create an addition to the total volume of money in just the same way unless the recipient utilises the funds to repay a previous loan from another bank.

Investment Creations

When we come to the investment in securities, here, at last, one would imagine, we have something quite distinct. But again examination will show that the process is not in the least different in its final results. If for instance the purchase is made from a customer of our bank, we credit his account, so increasing the bank's liability on current account against the new asset 'Investment Account,' and thus we have again created an addition to the volume of money. In form there is no distinction between what we have done here and in lending the money to a customer on loan account to enable him to purchase the identical securities. The bank would naturally prefer this alternative if the customer were a person of substance, for his would be the risk of a fall in the market value, equally with the benefit of any rise; in neither of these is a bank

legitimately interested since it is not its true function to work as an investment trust.

Bank Premises Creations

Strange as it may appear at first sight, a purchase by a bank of land or building for a new office or expenditure upon renovation of an old one is, equally with all the preceding cases, a creation of money to the extent which it is not paid for out of profit and loss account, for the payments debited to this asset called 'Premises Account' create a new credit balance in the name of the builder, contractor, or landowner, or supplier of fittings and furniture. In practice, however, a bank amortises its premises account by transfer from profit and loss account as rapidly as possible and such amortisations reduce the volume of money again.

It will be quite evident to the reader by now how absurd is the statement, so commonly made, that banks lend out their customers' deposits to borrowers, when the truth is that every lending simultaneously makes a fresh deposit.

The Limit of Creation of Bank Money

It may be wondered what limit, if any, there is to this creation of money which, it seems, is so simply effected. The answer is that the process is governed by the amount of 'cash,' in which term is included gold and silver coinage, bank notes, and the bank's balance at the Bank of England. By the convention already mentioned, the banks keep at least 10 per cent. of the total of their liabilities to customers upon 'current, deposit, and other accounts,' in cash. If, therefore, a bank finds that its balance at the Bank of England is running low it will cease from making further loans, and may even call in loans it has already granted to the 'money market,' which is of course the reservoir from which urgent and floating requirements are drawn. If the payments of a bank, by reason of cheques drawn by its customers in

favour of customers of other banks, together with its own payments to non-customers in respect of securities and other purchases, are greater than its receipts from cheques drawn on other banks in favour of its own customers and in respect of other banks' payments, the depletion of its Bank of England balance will be matched by increases of those of other institutions. The latter will thereby be enabled to make fresh loans or buy further securities. It follows, therefore, that with a given aggregate volume of money at the Bank of England in the possession of the various banks, a general volume of bank credit will be created up to the maximum extent permitted by the conventional proportion between cash and deposits. Each bank will endeavour to utilise profitably any excess in its account at the Bank of England, and it will buy securities if nothing else offers itself. Whilst the conventional figure, then, is 10 per cent., the creation of bank credit is limited to ten times the amount of the banks' balances at the Bank of England and the coinage and notes held by them.

Creations of the Bank of England

Coming to the kernel of the matter, we have to inquire how the balances of the banks with the Bank of England come into existence. The answer is that the Bank of England creates credit in precisely the same manner as the banks do, but with the difference that its creations are reflected almost solely in the balances of the other banks. The same applies to its cancellations of credit. Let us see how this comes about by considering an example or two.

—by Ways and Means Advances

Suppose the Government has taken a loan from the Bank, a proceeding which is termed 'borrowing on Ways and Means.' The books of the Bank would at that moment show an increase in 'Government Securities'

on the one side and 'Public Deposits' on the other by the amount of the loan. The Government Departments disburse the money by cheque to their suppliers, such as armament makers, army caterers, naval furnishers, or road contractors, to salaried officials such as Cabinet Ministers or Civil Servants, and to the thousand and one other suppliers of goods or services, all of whom pay the cheques into their banking accounts with the banks throughout the country. These latter present the cheques to the Bank of England, with the result that 'Public Deposits' are depleted whilst 'Other Deposits—Bankers' are increased.

Naturally, the reverse operation occurs when you issue your cheque to the Collector of Taxes, for the 'Public Deposits' are increased to the detriment of 'Other Deposits' when the Inland Revenue pays into the Bank of England the sums so collected from taxpayers. If a 'Ways and Means' loan is then repaid by a transfer from 'Public Deposits' a cancellation of credit has occurred.

Again, if the Bank discounts a block of Treasury Bills for the Government or purchases a new issue of a Government loan and the money is disbursed, the same thing occurs as in the case of 'Ways and Means' advances, the other banks' balances being increased thereby.

—by Loans to the Money Market

Take an example of a loan granted by the Bank not to the Government but to one of the Discount Houses which has been 'driven in to the Bank,' as the phrase goes, by the calling in of a loan by a London bank and which cannot find another bank willing to make one to replace it. The Bank thus increases its 'Other Securities' by the amount and the funds are credited to the calling-in bank, thus enhancing 'Other Deposits—Bankers.' When the Discount House is in a position to repay the Bank out of funds raised by a loan from a London bank, when conditions are easier, the reverse process ensues and

the 'Other Deposits—Bankers' and 'Other Securities' alike are reduced in the books of the Bank of England.

—by *Gold Purchases*

Now let us consider the case of a consignment of gold from South Africa—always a very important transaction, especially in the days of the Gold Standard. If the Bank of England buys this from the producers, *via* a bullion broker, it hands the latter its cheque or 'payment' for the value, which the broker pays into his account with a joint stock bank. The latter, in turn, pays in the cheque to its account with the Bank of England, which credits the account of the joint stock bank on its books and charges the cheque to 'Notes held' account in the Banking Department. It passes the latter entry because the gold will have been handed to the Issue Department, which issues notes in exchange to the Banking Department for the value thereof.

The result of this sale of gold, worth £*x*, is reflected in the following bookkeeping entries which will have been passed on the accounts enumerated:

LIABILITIES (Credit entries)	ASSETS (Debit entries)
<i>In the Issue Department of the Bank of England</i>	
'Notes Issued—Banking Dept.' £ <i>x</i>	'Gold Coin and Bullion' £ <i>x</i>
<i>In the Banking Department of the Bank of England</i>	
'Other Deposits—Bankers' . £ <i>x</i>	'Notes held' . . . £ <i>x</i>
<i>In the Joint Stock Bank</i>	
'Bullion Broker's current account' . . . £ <i>x</i>	'Balance at the Bank of England' . . . £ <i>x</i>

—by the '*Open-Market Policy*'

Finally, we must discuss the case where the Bank of England of its own volition decides that an increase in the general volume of money is called for. If the Government is not in need of funds, and nothing offers elsewhere, the Bank exercises what is called the 'open-market policy' and proceeds to purchase Government

securities upon the Stock Exchange. The resultant creation of money is shown on the one side by the increase in 'Government Securities' and on the other in 'Other Deposits—Bankers,' for the sellers of the stock pay in the Bank's cheque to their account with a London bank which in turn receives credit from the Bank of England.

If, however, equally of its own volition, the Bank of England decides that the general volume of money is too large, it sells securities on the open market, and the cheques drawn on London banks which are received from the buyers of the stock result in the depletion of the 'Other Deposits—Bankers' and 'Government Securities.'

Control of the Volume of Money

It will now be clear that the Bank of England holds the keys of the position and is able to control the volume of money through its power to increase or decrease the amount standing to the accounts of the other banks. The same question as before naturally arises as to whether there is any limit to the issue of credit by the Bank of England. In the Gold Standard days the amount was limited by the amount of gold held by the Bank, since the Bank under the 1844 Act could issue notes only against gold, pound for pound. A lack of gold and consequently a lack of notes held by the Banking Department as its reserve, prevented any creation of money when the proportion of the notes fell below the conventional figure, which in the case of the Bank was round about 40 per cent. Thus, broadly speaking, unless the gold holdings of the Bank increased, credit creation was prevented.

To-day we are no longer on the Gold Standard and the position is different. The creation of credit still bears a relation to the reserve of notes held by the Banking Department, but since the fiduciary limit is such an elastic quantity it can, and there is little doubt

that it will, be stretched to whatever figure is necessary to support any creation of credit deemed necessary by the Treasury and the Bank of England working in consultative harmony.

Application of the Control

The practicalities having been described let us now gather the threads together and endeavour to view the question from an administrative angle. Let us assume that in times of peace the index of wholesale prices has steadily been falling and, consideration having been given to the matter by the authorities from several aspects, it is decided to increase the volume of money in the hope that demand for commodities will thereby be stimulated. The old method of reducing the interest-rate level in the expectation that borrowing by industrialists will be encouraged thereby is no longer effective, since interest is already at such a low ebb that it is impracticable further to reduce it; and in any case experience has shown that commercial borrowers are not greatly influenced by low rates. The authorities then, observing that there is little likelihood of a spontaneous demand arising, decide to manufacture credit and they can only effect it by purchasing securities. This immediately creates purchasing power in favour of the sellers of the stock, which they may, or may not, exercise by purchasing commodities or investing in new undertakings which stimulate the demand for capital goods. In any case, the volume of the creation remains to the credit, at the Bank of England, of the account of the bank with which the security vendor keeps *his* account, or of some other bank or banks to which it has been transferred as a result of the vendor's purchases. Wherever it may lie, the possessing banks will now be in the position of holding 'idle' money over and above their needs under the 10 per cent. convention and will endeavour to 'lend' the extra amount which they hold, purchasing securities if no better way appears. They

will still have the same amount of cash at the Bank of England if the sellers of the securities happen to be their own customers, but if these vendors are instead customers of other banks, then some part of their Bank of England balance will be transferred to the account of another bank or banks. However it may run, the point is that the original creation by the Bank of England still remains spread over the banks although they have made two creations themselves on the strength of their increased cash; once when the original vendor to the Bank of England was credited and again as just described. The process then may be repeated the equivalent of eight times more, when at last the resultant collective deposits on their books will show the conventional percentage to cash and their creations must cease.

Now, as a result of their response to the Bank of England's original creation, the banks have put purchasing power into the hands of their customers which amounts in all to about ten times the amount of the Bank's security purchase. If the new purchasing power is utilised to buy commodities either in the form of consumption goods or capital goods, and the money continues to circulate in similar further purchases, the object of the creation has been achieved, for the increased money volume has been applied to the purchase of goods and a rise in the price-level will have occurred. If, on the other hand, the new money lies stagnant in the bank accounts of the recipients, all that has happened is that an increased volume of money has been set off by a decreased velocity and no increase in the price-level results. In such an event it is then a question for the authorities to decide whether they shall effect a further creation in the hope that it may fall into more responsive hands, or whether they shall leave the matter to develop later.

There is no need to go into much detail in discussing the opposite case of where the prices, in the opinion of the Bank of England, are rising too rapidly. In such an

event the Bank sells securities, which has the effect of reducing 'Other Deposits—Bankers.' The banks, finding themselves short of 'cash,' are forced to reduce their creations of credit by selling their own securities, by letting bills run off, or in the last resort by calling in loans from their manufacturer and trader customers; this last expedient is very effective in directly reducing prices, for forced sales of goods are thereby rendered necessary. The banks will have to reduce credit by ten times the amount of the loss of their cash at the Bank of England in order to restore their proportion between 'current accounts and deposits' and their 'cash.' A reduction of credit is generally more immediately efficacious than an increase in affecting the price-level although it is conceivable that the early effect of a reduction might be to cause transfers from deposit accounts to current accounts, so keeping up the velocity of spending for a time.

The Unbalanced Budget

As mentioned earlier, it is this question of responsiveness which makes the problem so uncertain. If as a result of a creation by the Bank of England the funds are directly spent in industry, as they undoubtedly are if the creation arises from a loan to the Government, the effect is immediate; hence the popularity of ideas for stimulating trade in times of depression by Government expenditure on road-making and other national development schemes, and hence the calls made for an unbalanced budget which obviously requires loans to make up the deficit not covered by taxation. It is the hope of such advocates that stimulated trade may increase the yield from existing taxes and so enable the loans then to be repaid whilst industry carries on without State intervention. If, however, the creation by the banks is effected by securities purchased, there is a strong tendency for the funds to be stagnant in the banks, since sellers of securities do not usually care to spend their realised

capital in consumption goods; the best hope is that they may be led to invest the money in new concerns which will purchase 'capital' goods to fit out their factories and workshops.

It will be realised that the ideal creations of money on the part of the banks are those resulting from loans made to manufacturers for the purpose of producing fresh consumption goods. The money thus created is spent on raw materials and also paid away to labour, which immediately purchases consumption goods to the full extent and so starts a cycle of circulation which stimulates trade in general. Another advantage of this kind of creation is the very important one that ultimately, when the new goods have been produced by the manufacturer, and pass into consumption, he repays his loan with the proceeds and the creation is thereby cancelled. Further there is a strong tendency for such an increased goods production to be stimulated without increase in the price-level owing to the concomitant money creation being in step with the output. The result is an increased standard of living.

The Ideal Form of Money

The perfect form of bank money would be that which is exactly matched by goods in process of manufacture, because income on the one hand consists of payments received for one's work or services for the commonwealth whilst expenditure is the money we give out to acquire the result of the work or services of other people; thus the money provided by borrowings to turn out new goods produces the income, and the money expenditure later repays the borrowings in respect of that particular lot of goods as they go into consumption. In the ideal world, the income and expenditure should exactly match each other so that no waste in the form of unconsumed goods occurs. The question of savings is, of course, a complication but that is, or rather should be, merely a question of the proper balance between the

output of capital goods and consumption goods. The discussion of this matter, however, is one too wide for the compass of the present book and it cannot therefore be pursued further.

The Douglas Social Credit Theory

As we have seen, the creation of money results not only from the borrowings in respect of the manufacture of goods, but also from the purchase of gold and of securities, and to these factors a very large proportion of the volume of money is due. It is in the failure to realise this fact that the Douglas theory is at fault. The adherents of 'Social Credit' assume, so far as the somewhat nebulous presentation of their economic arguments allows us to gather, that money and purchasing power to buy goods arise solely from the funds paid out by manufacturers during the processes of production. In his famous $A + B$ theorem, where A is the amount of money paid to individuals during manufacture and B , other payments, such as the cost of the raw materials, Major Douglas suggests that only the A portion of the money is available for the purchase of the finished article for which the maker requires $A + B$ in money, apparently ignoring the fact that raw materials are purely the result of earlier A payments, and anyhow even producers of raw materials must purchase finished goods. Again, he contends the cost of depreciation for machinery and buildings is a factor which is not passed into money circulation and therefore the amount of money available to buy goods is short by that amount as well as by the B payments. It is true that there is a 'lag' before savings for the provision of depreciation are expended, but it is only a lag and not a permanent withholding. He ignores entirely the enormous creations of money in respect of gold and securities, quite outside the processes of manufacture, which inject purchasing power into the general system and which are equally available to buy goods. The naïve idea of creating 'social credit,'

however it may be applied, is nothing but a creation without backing, not even being covered by securities as are the fiduciary or managed currency issues; social credit is therefore not subject to cancellation when inflationary price movements give warning that the volume of money is too high, for it goes on piling up in the monetary system with every article sold. The Douglasites appear to imagine that once money is spent it is finished with, but obviously such a belief is totally incorrect.

The experiment in Alberta, where a Government was elected with a mandate to adopt 'Social Credit' as a monetary policy, seems to have miscarried entirely. That Government made no attempt to fulfil its earlier promises to distribute the easy Social Credit money. One can only assume that the authorities there have found the difficulties insuperable and that they are convinced of the futility of the notion in practice, whatever they may have thought of it earlier in theory.

The Banks guarantee the Validity of Money

To return to the creation of bank money, it is necessary to consider the question of responsibility for the validity and worth of such money. We have seen that it is brought into existence, for instance, by a manufacturer borrowing; that person spends the money on raw material and labour and thus in effect has borrowed the actual services and material from the people who parted with them, and thereagainst he accumulates quantities of his new product with which he can repay those people in due course, either direct or *via* other exchanges of goods. If, however, his product becomes wholly or partly unacceptable he has insufficient with which to repay and he must therefore default. In strict practice and logic the money received by the givers of goods and services should be related to the goods which the manufacturer will produce.

Since, however, in practice money cannot be localised

and bound to the specific goods to which it gave rise, the banks act as the intermediaries between the manufacturer and his suppliers of goods and services. The banks thus become the creditors of the producer and the debtors of the suppliers. If in the final outcome the manufacturer is so unlucky or so faulty in his judgment as to turn out goods which are unacceptable to purchasers, and he has to default, it is the bank which has to make good that default, for it is clearly impracticable for it to claim an equivalent right to default towards its own creditors. Consequently it is correct to say that the banks in effect guarantee the holders of money in respect of the borrowers of money, and if any default takes place they (the banks) must make up the deficit in order to keep the money valid and so enable creditors to obtain acceptable goods in respect of their holdings as and when they require them. If a bank defaults, bank money to the equivalent of its deficit is cancelled and is lost to holders, as we saw often happened in the case of the country banks in the eighteenth and early nineteenth centuries.

There is another way in which the question may be viewed. A loan to a manufacturer, or to anybody for that matter, is an addition to the total purchasing power and as such enables the borrower to enter the market and acquire those goods, such as raw materials and food and the requirements of living for himself and his workpeople, which will enable him to produce and in due time to repay the community in the form of his own products. This benefits the whole community, therefore justifying the loan to the borrower and the consequent acquirement by him of existing wealth to which he would not be entitled were he not enabled by the bank loan to command what is in effect a forced requisition of the things he needs.

It will be seen from this fresh angle that the banks are in a position of great responsibility and trust, for they have to ensure that this power of requisition is not

granted to persons who are unworthy of it. Were they to grant it too freely or easily, not even their wealth and reserves could support and make good the defaults which would ensue.

Ethics of Interest charged to Borrowers

Finally, there is a point which often puzzles people who consider this power of creation of money by a mere stroke of the pen on the part of the banks. If, they argue, money is so created out of nothing, why should borrowers pay any interest at all? The answer will be clear to readers of these chapters, for they will have realised that the banks are compelled to guarantee the solvency of borrowers, to pay interest to holders of bank deposits and savings accounts, to submit to earning no interest at all on the 10 per cent. held in cash against the deposits and very little against the more liquid portion of their assets, to support depreciations in securities purchased with the object of keeping up the volume of the nation's money, and to endure many other large outgoings and small incomings. The charges made to borrowers therefore are fully justified on these grounds, and for the expenses of administering such a huge trust on the nation's behalf.

Reference to Chapter IV will show that the year's aggregate profits of the eleven London clearing banks were £11.3 millions, whilst the volume of money administered by them was £2,264.5 millions. Not all the profit is represented by interest charges, some considerable proportion being attributable to commissions charged for other services. But, even if it were all due to interest, the profit is less than one-half of one per cent. per annum. Actually the profit derived from interest alone is under one-third of one per cent., and nobody will pretend that this is any hardship to the industry of this country.

Despite ceaseless propaganda to convince us to the contrary, there is not, and cannot be, any such thing as

'costless' credit. To whatever body the creation of money is entrusted it will be subject to administration costs. The banks, by reason of their organisation and practice evolved during two or more centuries of experience, are assuredly the best fitted to handle the nation's money and to relate it, as far as may be, to the national productive capacity. Moreover they accomplish the task at the minimum cost to the country, because they are able to combine it with other closely allied activities.

Chapter XIII

THE BANKERS' CLEARING HOUSE

IN or about the year 1770 the London Bankers' Clearing House officially came into existence, but prior to that there was an unofficial one which arose out of the ingenuity, or perhaps the laziness, of some of the bank 'runners.'

When cheques on other banking houses were paid in by customers it was, of course, necessary to present them for payment. This was done by runners, who had to cover considerable distances, for the banks at that period were not all crowded together so closely as they became in later years. Consequently, it happened not infrequently that the runner from one bank, on his journey to present cheques at the office of another, crossed the runner from that bank on a similar errand to his own.

It occurred to some person of inventive mind that, if all the runners arranged to meet at a convenient hostelry, business might be combined with pleasure, and, moreover, a saving of boot leather and physical exertion into the bargain. It was therefore so arranged, and the respective runners there exchanged cheques, noting whether on balance they had to receive from, or to pay to, each of the other institutions. In the cases where they had to pay there would be no need for them to journey to the receiving banks, for, although history is silent on the question of settlement, presumably the other messengers would proceed in the normal manner and collect the difference between their 'ins' and 'outs' in bank notes and cash. Thus on the average each runner saved half the distance he would formerly have had to cover, to his great content, and doubtless the time so saved would be occupied in a way which caused similar content to mine host.

The Institution of an Official House

The scheme might or might not have been carried on with the authorisation and blessing of the partners of the various banks, although the tellers must have been privy to the arrangement, but in the year mentioned it was deemed desirable to recognise the method and place it upon an official footing. A room was therefore engaged at 'The Five Bells,' in Dove Court, off Lombard Street, which was possibly the original hostelry selected by the runners, and so the organisation of the first Bankers' Clearing House was instituted. All payments made were still effected in cash and bank notes but, as the runners had demonstrated, the method of settling differences effected a considerable saving in the ready money required to be kept by each banker, for he did not have to pay cash for all cheques drawn upon him but only for the difference between himself and each other bank if it were against him.

A few years later the Clearing House was removed to a larger room in a private house next door to the 'Five Bells,' and after several other migrations, including one to Lloyds Coffee House in Abchurch Lane, it finally settled down in 1883 in Post Office Court, Lombard Street. There it remained until 1938, when temporary premises were secured pending completion of the rebuilding at Post Office Court.

It will be remembered that at the time the Clearing House was instituted there were no banks in London other than private ones, the joint stock banks not being founded until some sixty years later, in 1833. One of the ways in which the jealousy and hostility of the private banks were manifested was by their refusing to extend to the joint stock banks the privilege of membership of the Clearing House, and it was not until some twenty years later that the private banks saw reason and allowed the others to enter in 1854.

The Country Clearing

From its inception until 1858 the House, as it is always called in the banking world, was not concerned with the clearing of cheques other than those drawn upon the City offices of the members, but in that year a momentous step forward was made, for the 'Country' Clearing was instituted. The provincial banks at that time had no branches or offices of their own in London and therefore it was essential for them to have London Agents, or Correspondents as they were more often termed. The institution of the new Clearing allowed country banks to clear cheques drawn upon other country banks through the intermediary of their respective London agents. In this manner it became possible for a bank in, say, Exeter to obtain payment of a cheque paid in by a customer which was drawn upon a bank in York, without the necessity for posting the article to the latter town and receiving in return bank notes or a draft drawn by the York bank upon its London agent.

The Metropolitan Clearing

The Town Clearing, as the original one was called, and the Country Clearing were kept quite distinct from each other, and in 1907 a third, the 'Metropolitan' Clearing, was instituted, comprising the banks in the London area but outside the City circle. If you examine your cheque-book you will find upon each form a bold initial printed in the left-hand bottom corner, which will be a T, an M, or a C, according to the location of the office where your account is kept, the initial indicating the London Clearing which serves that office.

The Clearing Operations

Let us now turn from the historical to the practical aspect of the subject and inquire how the clearing operations actually work. During each working day customers of banks all over the country are paying in to

the credit of their accounts cheques which they have received from their debtors and buyers. Clerks in each branch bank are detailed to enter in appropriate record books or sheets sufficient details of each cheque to enable it to be recognised and traced in case of inquiry. These cheques are stamped with the crossing stamp which shows the name of the bank and branch, rapidly sorted into the different categories with the aid of the initials T, M, and C, and are separately listed in prescribed ways. Finally they are dispatched to the head office of the bank in London, or to the London agent in the few cases of the purely provincial banks.

Upon their arrival, next morning, the London office amalgamates the mass of items, keeping each category separate, and the grand totals of cheques drawn upon or payable through each clearing bank is so ascertained in the three categories. Armed with their own total figure and the mass of cheques, the bank staff concerned with the Metropolitan Clearing proceed to the House, for the Metropolitan is the first to be dealt with, opening at 9 A.M. (Saturdays 8.45 A.M.), cheques being deliverable up to 10.30 A.M. (Saturdays 9.50 A.M.). The batches are distributed to the desks of the different members, there to be handled by the staff of the drawee banks, who sort them out into the branches upon which they are drawn. During the forenoon, messengers from the Metropolitan branches will call at their head offices, pick up these cheques and take them to their respective offices, where they are then examined and, if paid, debited to the accounts of the drawers. If a cheque is unpaid by reason of some technicality, or through lack of funds, it has to be 'returned' direct to the 'crossing bank' by post, and the value is claimed back in a certain manner from the head office of the presenting bank.

In the meantime, the clearing clerks in the House will have ascertained the total of the claims against them in respect of the mass of cheques which they have received ('Ins'), and by comparison with the figure of

the claims they have to make against the cheques which they have presented to the other banks ('Outs') they will calculate whether they have to pay or to receive on balance, and how much. It is obvious that the total of all the 'pays' in the House will be equal to the total of all the 'receives' if the work has been accurately done. Upon agreement, each bank which finds itself in the position of having to pay authorises the Bank of England to debit its account with the total requisite sum, whilst each bank which has to receive advises the Bank of England how much it claims, and the transfers are duly made on the next day. It will be observed that the banks do not settle individual differences with each other as in the early days, but each one either pays or receives a single amount in respect of the whole of its Metropolitan Clearing for the day.

The Country Clearing is handled in precisely the same way, the cheques being taken down to the section of the House devoted to that clearing from 10.30 A.M. to 12 noon (Saturdays 10-11.5 A.M.). The received cheques are posted by the head offices the same evening to the drawee branch offices; settlement in the House is made two days after the exchange of cheques has taken place.

The Town Clearing, which of course in point of turnover is by far the most important of the three, takes place twice each day, at 10.30-11.5 A.M. (Saturdays 9-10.20 A.M.) and in the afternoon at 2.30-3.50 P.M. (Saturdays 12-12.35 P.M.). The morning section is devoted to the cheques received from the country and to those in the City area which might have been shut out the previous afternoon, as well as to maturing bills. The second clearing deals with the items paid in at the City offices during the day, and the volume both as to numbers and value rises to incredible heights. When it is remembered that customers could pay in cheques up to 3.30 P.M. at their banks in the Town area and rely upon them being presented and paid the same day it will be seen what expedition is required on the part of the banks

to enter and list them, rush them to the House before 3.50 P.M., clear them through to the drawee banks, who must examine them and, if any are unpaid, get them back to the House before 5 P.M. For if none arrives by then it is assumed that all have been paid. Settlement is made in respect of the whole Town Clearing on the same day.

The data given above all relate to the pre-1939 period. It was one of the precautions arranged before the War that the Clearing House would be evacuated to the provinces if hostilities should break out. Accordingly the organisation was transferred in September 1939; it has since resumed operations in London, with some minor changes in the times of the three clearings.

The Volume of Business

A few statistics will show the magnitude of the task which normally confronts the London Bankers' Clearing House. In the record year of 1929 a little under forty-five thousand million pounds (£45,000,000,000) was passed through, of which the Town Clearing accounted for £40,000,000,000. The daily average in that year was £130 millions for the Town, £6 millions Metropolitan, and £10 millions for the Country clearings. In 1938 the figures in round millions were £110, £7, and £12 respectively, whilst on Stock Exchange settlement days the 'Town' volume rose to £117 millions.

Such astronomical figures as these are apt to convey little to the layman without the familiar formula of 'placed end to end will reach to——,' but a visit to the nerve centre of the banks' clearing would impress the most casual observer with the organisation which can handle such an enormous volume of work in so short a time. There are no statistics as to the number of items, but if the average value of a Town cheque is as high as £500, and at a guess it is much less than that, it means that every day an average of nearly a quarter of a million separate items are handled in that section alone,

with such accuracy and speed that 'differences' are speedily found, and adjusted within a day or two.

Mechanical Aids

Naturally, the most modern mechanical methods have to be pressed into service to render possible such a Herculean task. Electric adding machines are a commonplace. Banks do not usually re-list the in-clearing but send it to each drawee branch office after sorting, and rely upon them to account for their correct total and so take their part in building up the agreement with the settlement grand total.

Even the cheques which go down to the country branches each evening are often not listed. Instead, each cheque, in some systems, is photographed with incredible speed on to rolls of film. This is done as a precaution against losses of letters in transit, or in the settlement of any query as to the interpretation of the hieroglyphic which you sometimes write upon a cheque under the mistaken impression that you have inscribed a figure. Incidentally, if bank customers realised the work involved and precious time wasted through badly written figures, they would ever after pay meticulous attention to their calligraphy, at all events when making out cheques.

The Provincial Clearing Houses

When discussing the Country Clearing, and the facilities it affords to banks in the provinces, it was suggested that all cheques with a 'C' in the bottom left-hand corner were forwarded to London for clearance. Whilst this is true in general, yet it would clearly be absurd for a cheque to travel from, say, Carlisle to London and back again to Carlisle to a branch bank situated next door to the collecting one. Actually, local exchanges of cheques in the same places are made and differences settled by drafts on London, or through mutual accounts, pending periodical settlements. But

in the larger cities it was speedily realised that local Clearing Houses would effect great savings in time and labour, and accordingly these were instituted, modelled largely upon their London prototype.

The most important of these, the Manchester Clearing House, was established in 1872, and this institution handles nearly £1.5 millions per day, the total for 1938 being £475 millions. The record years were in 1919 and 1920, the time of the great post-War boom, when the enormous cotton mill flotations were in progress and £1451 millions passed through in the second year mentioned. Manchester clears for all branches of the indigenous north-country banks (except those offices in the Liverpool district, which has a Clearing House of its own), and for the offices of the London banks in the Manchester district.

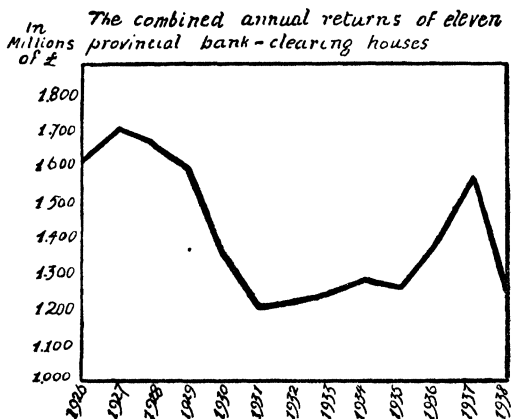
The next most important provincial Clearing House is that of Liverpool with £354 millions in 1937, although the total in 1938 had fallen phenomenally almost to pre-1914 level at £268 millions. It is followed at considerable distance by Birmingham with £121 millions turnover per annum. Other centres are Newcastle, Bristol, Sheffield, Bradford, Leeds, Hull, Leicester, and Nottingham, listed in order of importance. The total amounts cleared through the eleven provincial houses in 1938 amounted to £1258 millions.

Provincial Clearings as Trade Indices

The returns of these clearings provide a very useful indication of the velocity of spending, since the figures, except in the 1919 and 1920 period of industrial flotations, are much more closely related to purely trade turnover than those of the London House; through the latter there pass the enormous figures connected with home and international finance, issues, stock exchange settlements, and inter-bank transfers. These mask completely the trade turnover, and it is to the provincial figures that statisticians turn when they endeavour to

ascertain the comparative relation between the velocity of one year and another. One may often see the statement made that the Manchester Clearing House figures are up or down, as the case may be, in relation to last year and therefore a state of greater or lesser prosperity is in progress. Doubtless, these provincial returns are closely scanned by the authorities when money 'management' is under discussion.

The graph below, showing the provincial clearings,



will illustrate the movements in trade activity during the dozen years up to 1938. Note how the deflationary processes up to the time of leaving the Gold Standard in 1931 were reflected in the steadily decreasing trade turnover and how, with the subsequent cessation of deflation, the figures progressively improved until 1937. Do not forget, however, that this diagram cannot be taken as one denoting pure velocity; such a graph would have to take into account the effective volume of money and the volume of production. There are certain statistics which show the indices of production and we already know of those governing the volume of money, but the

present curve indicates only the course of total relative spending.

The most remarkable fact about the Clearing House system is that such colossal movements of money are settled without the passing of a penny in legal tender; the economy in cash holdings, which would otherwise be required on the part of the banks, is self-evident. But obviously trade on the modern scale would be well-nigh impossible had not the cheque system of payment and the Clearing House system of settlement been evolved.

Chapter XIV

SPECIAL SERVICES RENDERED BY THE MODERN BANKER

It will not be out of place in a book dealing with money, and therefore necessarily with the banking system, to discuss some of the methods by which banking touches the individual and the trader. Particularly does the foreign banking business concern monetary creation, as will have been gathered from earlier chapters.

The services performed by the modern banker are many and various; gone are the old days when he was merely a keeper and lender of money. The complexity of present-day life, following upon the subdivision of labour, had made it necessary for everybody to have recourse to specialists in other callings than his own. In all monetary affairs connected with the transfer of wealth, goods, and services the banker is the consultant to whom members of the community turn. But often the latter, reliant upon the integrity and disinterestedness of the banker, go still further and require him to purchase and hold on their behalf the actual symbols of wealth and claims upon industrial enterprise. Since as a rule they have neither time nor inclination to go direct to specialists in subdivisions of the generic order, such as insurance and stockbroking, nor do the modest extent of their requirements perhaps justify direct approach, the banker is increasingly called upon to act as their intermediary. Consequently we find that when a customer has accumulated a balance upon his account, in excess of his anticipated requirements, he consults the bank with the object of obtaining investment recommendations. Having ascertained the type of security required — gilt-edged, industrial debenture, preference or equity, mine, plantation, or still more

speculative security, which progressively combine greater yield with lesser safety—the bank requests the stockbroker specialist to make and submit an appropriate selection.

Investment Recommendations

From these the customer makes his choice, being guided perhaps by the comments and data relative to each recommendation thoughtfully provided by the expert, and instructs the bank to make the necessary purchase. It may be that the bank will be asked to take the matter completely into its own charge by having the purchased shares transferred into the name of the bank's nominee company. By this action the customer avoids all further trouble, for the bank will arrange and sign all transfer deeds, both initially and when the securities come to be sold. Additionally, there is the advantage that if the customer should subsequently require an advance against the security of the shares, the transaction is greatly facilitated by the fact that they are already in the name of the bank's nominees.

Securities and Dividends

In any case, whether in the customer's or the nominee's name, the bank will supervise the transaction and in due time will, if desired, hold the share certificate in safe custody on his behalf. All this it does without charge for, by custom, the stockbroker shares his official brokerage with the bank; the cost to the customer is, therefore, the same whether he uses the intermediary of the bank or goes direct to the stockbroker. Although the latter works for the lesser remuneration when the bank passes the order, he has some advantage in that he is sure of the fulfilment of the contract, which is valuable in the case of dealings of a speculative nature. The bank will be happy subsequently to receive the dividends direct from the companies so that the customer is not troubled with the warrants.

In addition to taking charge of registered securities, the bank undertakes the much more onerous task of guarding bearer bonds. These, of course, being negotiable by mere delivery, without the need for the meticulous process of transfer and registration, are prone to loss by theft or fire, and it is in the highest degree unwise for a possessor to keep them at home other than in a fire-proof and burglar-proof safe. But more important still, the bank when holding your bonds will watch the drawing lists, the dates of the coupons, and collect the value thereof, as well as look after possible options or conversion rights on your behalf. Again, a customer often takes advantage of this cost-free service of safe custody by depositing with the bank valuables in a sealed packet or locked box. This is particularly useful when, for instance, the house is to be left locked up during the holiday season and the customer does not wish to expose to theft irreplaceable articles having a value which mere monetary insurance cannot cover. The bank will always be willing to accept the trust provided the packet is not too bulky for convenient storage.

Personal Credits

Although travelling abroad is still subject to controls for any but the Government official or diplomatic personage, this will not always be the case. When therefore the financial restrictions upon foreign exchange or 'free' sterling (which are discussed in the final chapter) disappear, the following details will once again be useful.

The bank can arrange for your cheques to be cashed anywhere from Margate to Samarkand up to an agreed figure. All you have to do is to let the bank know the period for which you require the arrangement to be available, how much you are likely to want to encash and hand in a specimen of your signature, and the matter is complete.

Travelling Facilities

If, however, you are not likely to be located in a single place but will probably travel about, it is better to take either a Letter of Credit or Traveller's Cheques. The former is the more suitable if an amount of, say, £100 and upwards is involved and the journey is abroad. When you require funds you go to the agent in the town where you happen to be, who is indicated in the booklet supplied by the bank, there to draw a draft upon the head office of your bank as directed by the terms of the Letter of Credit. After the foreign bank has verified the signature from the Letter of Indication, which your bank also gives you with the main document, and has marked off the amount drawn upon the Letter of Credit, the foreign currency will be given to you at the current rate of exchange, less stamps, if any. Do not, however, expect to be able to draw sterling notes abroad; in large centres, where there is likely to be sterling offering, you might be lucky enough to get it if you so desired. You would, however, usually have to pay the foreign bank a fairly stiff commission for the privilege.

In other cases, the Traveller's Cheques provide a simpler mode of obtaining funds at home or abroad. They are usually issued in units of £10 and £5, although some banks issue them for still smaller amounts. Your signature has to be written on each cheque at the time of issue, and when you wish to encash one you will be required to sign again in the indicated space and in the presence of the paying bank cashier. All travellers abroad, wherever it may be, should discuss the matter with their bank, for the extraordinary conditions prevailing almost everywhere will raise problems of which it is necessary to be aware before undertaking the journey; otherwise, you may find yourself in the unhappy position of being held up on the frontier, if not prohibited from entering the country, because of an inadvertent neglect of some regulation. Incidentally,

another service which your bank will render you is to procure your passport, if you do not already possess one, or to get an old one renewed if necessary. A personal recommendation is essential before the Foreign Office will issue a passport and your bank manager is one of the few classes of officials whose endorsement of approval is accepted.

If your holiday abroad consists of touring in your own car you will have to obtain triptiques from the Automobile Association or the Royal Automobile Club to avoid paying duty in the visited countries. These institutions require cash deposits of considerable amounts unless your bank guarantees the arrangement, which it is always willing to do.

Standing Orders

It may be that you have made purchases, such as the motor-car itself, on the hire-purchase system, or possess an insurance policy the premiums on which may be paid by monthly instalments: in such cases it is generally asked that you lodge a standing order with your bank arranging for the payments to be made on your behalf. The bank is quite willing to do this, as it is also to make any periodical payments such as club subscriptions, charitable donations, and the like. It will act as expert adviser in your income-tax affairs, making your returns and obtaining any refunds that are possible.

The Executor and Trustee Department

The bank, ever happy to serve your interests, is willing to carry on even after your unfortunate demise. It has a well-organised and efficient Executor and Trustee Department which will be ready to act in either capacity if you should appoint the bank. It is always a little invidious to have to ask friends or relations to act as the executor to your will, for it saddles them with responsibility and work, both of which they are usually ill-equipped to sustain; besides, they might predecease you,

in which event you will have to start all over again. The moderate fees charged by the bank for its services in this direction are well worth while, and you will be assured of an expert and legally correct disposition of your wealth in accordance with the terms of your will.

All the services so far discussed are personal ones, but there are others available to the trading and manufacturing firms or companies, and are tasks which usually require handling on a large scale. Here again the present war regulations interfere seriously with the freedom of trade, but the following notes will once more be fully as valid, as in pre-1939, when the emergency has passed. The first question is that of foreign exchange, which, however, has chapters specially devoted to it, so we need not discuss the matter here.

Foreign Collections

Another class of business is concerned with the collection of documentary bills for the export trades. A manufacturing concern has sold abroad, either for sterling or for the currency of the buyer, a quantity of manufactured goods. The shipping agent of the concern has arranged for the goods to be put on board a suitable steamer bound for the foreign port designated by the buyer. A bill of lading is issued, which is in effect the captain's receipt for the goods and which cites the details of the consignment, quoting the marks and numbers which appear on the packages, and this reaches the manufacturers after the ship has sailed. They proceed to make out invoices at the price designated in their contract with the buyer. This price may be one which includes all expenses up to the time the goods are placed on the ship and it is known as an f.o.b. price (free on board). On the other hand, the manufacturers may have calculated their selling price at such a figure as enables them to deliver the goods free to the buyer at the port of destination, which means of course that they (the manufacturers) will have to pay the cost of freight

and insurance for the voyage. Such a price is termed c.i.f. (cost, insurance, and freight). In both these cases the seller is entitled to his money as soon as he is able to hand over the documents to the buyer or to his agent. There is another mode of price quotation which occurs in some markets—generally those far distant, such as India and China. It may be arranged according to the contract that the buyer is to receive some credit, perhaps two or maybe three months, and the seller will have quoted a price inclusive of the c.i.f. value, together with the cost of interest involved in the deferred payment. Such a price is known as c.i.f.c.i. (cost, insurance, freight, bank charges, and interest).

Accommodation upon Foreign Bills

Whatever the mode of price quotation used, the manufacturers will hand to the bank the bill of lading, invoices, and insurance policy, perhaps accompanied by their bill of exchange drawn upon the buyer. The bank will send these to its correspondent abroad for the cost to be collected from the buyer against surrender of the documents. If the manufacturers require an advance against the shipment, the bank is generally happy to accommodate them. In such a case, a Sterling bill accompanied by documents will either be purchased or advanced against, according to the custom relative to shipments to the country of destination. A bill in the foreign currency will be purchased at the Bank's buying rate of exchange for that class of instrument. In all cases, however, recourse is preserved against the manufacturers, and if the bill should be dishonoured by the buyer the former will be responsible to the bank.

Bankers' Credits

The importers' interests, too, are served by the bank in many directions. At the very outset of a purchasing contract made by him he will perhaps require the bank's

services, for it may occur that the foreign seller demands a 'Banker's Credit' before he is willing to ship the goods. We saw in Chapter V how the merchant-bankers aided the trade of the country in this direction, and the banks to-day offer precisely the same facilities to their customers.

Let us assume that the importer has contracted to buy 5000 cases of oranges from South Africa, 'payment to be guaranteed by confirmed London banker's credit.' He requests the bank to extend to him the necessary facility, and if the bank has sufficient confidence in him it will be agreeable to open the desired credit. Since by so doing the bank renders itself liable to make payment against a consignment of oranges, the acquisition of which is the last thing it desires for itself, it will probably require a cash margin from the customer to be held until the transaction is completed. It will be apparent that if he defaults, the bank will be saddled with oranges which it has to sell elsewhere as best it can, and the proceeds in such an event may not amount to as much as has been paid to the South African shipper. At all events, since the bank is willing to accommodate its customer, it opens the desired credit. This is in the form of a printed letter addressed to the prospective shipper, which undertakes to pay him a specified amount provided that he tenders specified documents, such as signed invoices, insurance policy, and bills of lading, on or before a certain date; the letter goes on to declare that the undertaking given therein is irrevocable and therefore will not be withdrawn. The shipper then is in a safe position to pack and dispatch his goods to the port and to have them placed on board ship destined for London, Hull, or other English port. Armed with the complete documents and the London Bank Credit he will find no difficulty in persuading his local bank to purchase the documentary bill on the London bank. It may even be that the latter has requested a South African bank actually to pay the exporter on its behalf.

Upon arrival of the documents in London the importer will be requested to take them up by payment of the amount. If he requires a period of grace until the ship arrives, and his own buyers are ready to take delivery, the bank will probably be willing to make him a loan upon the security of the documents. In due time the oranges arrive, are cleared, and stored in warehouse. The importer, or his buyer, then pays the bank the requisite amount and receives either the bills of lading, or delivery orders issued by the bank, which enables him to obtain possession of the oranges.

It may be that the bill drawn by the South African upon the London bank is at sixty or at ninety days' sight, in accordance with one of the terms of the credit. Such a credit is termed an acceptance credit and the English bank opening it will then accept the bill, which accordingly becomes payable some two or three months later. The South African bank which purchased it will naturally have given fewer South African pounds since it has to wait longer for its money in London. But nobody is anxious about that, for the exporter calculated his price in anticipation of the period; the South African bank has a first-class asset in the bill, which it can discount and turn into immediate cash in London if it so wishes; the English importer has two or three months' credit whilst he looks around to effect his sales of the merchandise.

Unconfirmed Credits

In some cases the parties do not require the bank's guarantee to the transaction and a simple notification to the seller that the transaction will be financed upon presentation of specified documents, without actually undertaking to do so in all circumstances, is quite sufficient. In such an event the bank opens an 'unconfirmed' or 'revocable' credit, which is naturally cheaper to the customer, since the bank is not required to undertake any onerous direct obligation on his behalf.

Credit Information

Another service given by the bank which merchants find invaluable is that of obtaining 'credit information' upon other firms and individuals, whether at home or abroad. If a customer contemplates entering into business relationship with some other person or firm he asks his bank to make inquiries as to the business morality and responsibility of the latter. The inquiries are usually limited to the question of trustworthiness, coupled with one as to whether they may be considered good for a stated amount in a specified course of business. Thus, if you contemplate a series of transactions with X & Co., which may involve being out of your money to the maximum extent of, say, £300 at any one time, you will ask the bank to inquire 'whether X & Co. are trustworthy, and good to the extent of £300 on open account.' If, again, the transactions are secured ones you would inquire if 'X & Co. are good for, say, £5000 goods against payment.' The answer to the first may well be 'perfectly trustworthy, and good to the extent mentioned'; to the second it might be 'quite good' or 'figure higher than we see in a single transaction: good if in a well-spread series.' On the other hand, in a doubtful case the reply might be 'unable to speak for your figures,' from which it might be inferred that caution is recommended.

Even you yourself when opening a credit account with one of the big stores, or when seeking to rent a house or a flat, or making a purchase on the deferred-payments system, will be asked for the name of your bank so that an inquiry may be instituted as to your responsibility in respect of such transactions. Hence the advisability of frankness with the bank manager, for even when your means are not large he will be able to give a satisfactory report if his knowledge of you assures him that you will not undertake anything you do not feel reasonably certain of being able to fulfil.

There are many other ways in which the bank is of service to its customers, but enough has been written in these chapters to give a general idea of the more important functions which a bank carries on in the interests of its trading as well as of its personal constituents. Any proposal or call for advice on financial matters is certain to receive sympathetic consideration even if circumstances do not permit the bank always to accede to your requests for accommodation. But no reasonable appeal is ever refused. For one thing, a bank exists to make a profit and profits arise out of business. The motto of every bank manager is 'spread the risks widely,' and in pursuance of that policy he believes that 'little fish are sweet'; accordingly you may be assured that your business is as essential to the welfare of any bank as that of the greatest financier. Indeed, the internal bank statistics show that the average overdraft or loan is an astonishingly low figure, although to listen to the critics of British banking one would imagine that the modern Croesus is the only person whose interests are consulted. You may be assured that this is not so. The customer who deals in large figures is naturally able to command finer rates, just as does the wholesaler in commerce, for the 'overhead' must be allocated with reference to the work involved. The sensible person, therefore, accepts the position as a reasonable business axiom and does not draw the conclusion therefrom that the bank is not desirous of his custom.

Last but not least are the extra services which Exchange Control has entailed since 1939. Banks are expected to act in a dual capacity, as agents of the Bank of England which operates the Control, and as advisers to their customers on the many obligations under the Act.

Chapter XV

FOREIGN EXCHANGE

THE business of foreign exchange arises whenever a transfer of money takes place between one country and another. These transfers may originate from the sale or purchase of goods, from foreign travel (which in effect is the equivalent of an import into the country of the traveller), or from financial operations between two countries. The World War has subjected the business to unprecedented control and dislocation, as will be learned in the final chapter, but the principles remain unaltered.

Every transaction in foreign exchange involves four parties, that is, two in each country; there will be a giver and a receiver of sterling in this country and a receiver and giver of the foreign currency in the country involved. If, for instance, you have bought goods from Sweden at a price quoted in Kroner, you will enter the foreign exchange market to purchase the requisite amount of Swedish currency. Having found a party possessing that currency who is willing to sell, you make a deal with him, possibly after some haggling over the price. He then instructs the party holding the Kroner, probably his bank in Stockholm, to pay the amount to the person from whom you bought the goods; you on your part hand over the equivalent sterling to the party in the foreign exchange market, calculated at the agreed price.

In practice you do not actually go into the market yourself, but, as with so many other matters, you instruct your bank to arrange the business for you.

It may be that, instead of making a contract with the Swedish merchant in Kroner, you have bought on a sterling basis and send your cheque in settlement. He then instead will have to initiate a foreign exchange transaction and his bank in Stockholm will purchase from him the sterling cheque at a negotiated rate,

sending the item to London for the credit of its account. A four-cornered transaction has occurred in just the same manner as before—Sweden: bank and merchant; England: banker of the Swedish bank and yourself.

The Rate of Exchange

A few words as to the agreement of the rate of exchange will be appropriate at this point. The simplest way of regarding the matter is to consider foreign currencies as commodities, the prices of which, as you well know, vary according to the relative strengths of supply and demand. Just as you may buy oranges at seven for a shilling, so you may buy Kroner at 20 to the £1. If a sharp demand for oranges arises they may become more valuable, at six for the shilling; in similar circumstances the Kroner may appreciate so that you can get only 19½ for every £1. In the reverse case a large shipment of oranges will cause them to be offered strongly and the number will rise to eight; in the same event of large offerings Kroner will move to 20½.

Foreign Exchange and the Balance of Trade

Leaving the parallel, and concentrating upon variations in the Kroner rate, we first must observe that Kroner in the London foreign exchange market arise almost entirely out of purchases of British goods and services by Swedes, just as sterling in the Stockholm market arises out of purchases of Swedish goods by the British nation, ignoring for the moment financial transactions. Naturally, the same applies to trade between Sweden and other countries. Hence, if Sweden has made larger purchases abroad than she has made sales, the Kroner is offered generally, and it tends to fall in value, that is to say, more Kroner are exchanged for the foreign unit than before. Naturally, in the reverse circumstances the opposite occurs.

It may be objected that Sweden conceivably can have a surplus of sales of goods with some countries and a

surplus of purchases with others. The immediate result would be that the Kroner rises in value in exchange for the currencies of the 'surplus sales' group and falls for the 'surplus purchases' group. The natural tendency, however, would be for Sweden to pay the countries where she has over-purchased goods by transferring to them the currencies of the countries which she has acquired by the 'over-sold' goods. For instance, if she has a surplus of sterling and a shortage of dollars, as a result of trading, she will offer sterling in New York in exchange for dollars and pay her U.S.A. creditors therewith. Such operations are called 'arbitrage transactions' in the foreign exchange markets, of which more in due time. As a result of these transactions the Kroner rates of exchange with other countries all tend ultimately to level up; they show a fall in value, similar in extent, when Sweden has an unfavourable balance of trade, that is when she has purchased more than she has sold abroad, and a rise when she has a favourable balance of trade.

All this may sound somewhat complicated, but a description of the working of the foreign exchange market will perhaps clear the position. We shall view the market from the angle of a London exchange dealer's office, realising that in every capital city there are similar units working on the same lines.

All the large London joint stock and private banks, as well as the colonial and foreign banks and merchant-bankers, are dealers in foreign exchange and they, together with a number of brokers, form what is technically known as the 'market.' The brokers, however, are only intermediaries, and they derive their profit solely from the brokerages paid to them by the dealers on the transactions which they are instrumental in arranging.

Exchange Dealing

The dealing-room of each bank is where the actual operators in exchange work, of whom there may be one

or two in the smaller and many more in the larger institutions. These men sit round a telephone switch-board from which radiate private wires to the brokers and post-office lines to the outside world in general. Whenever an inward call appears it is announced on the modern 'boards' by an indicator light appearing on each dealer's section, and by a flick of the finger any of the men can instantly 'plug in' to that position and take the call. Each dealer is usually a specialist in certain currencies; one man may perhaps handle dollars, another francs, a third Scandinavian, and others South American, or the 'exotic' currencies as the more unusual ones are often called.

Each man knows the position of his stocks of foreign currencies at the beginning of the day, and he keeps a running account of the deals he effects so that at any moment he can tell what is his holding in each currency.

Imagine you are the 'American dollar man' and that at the start of the day's work you had a stock of \$5000 in hand. Orders to sell and to buy constantly pour in by telephone or cable from the Bank's branches and overseas customers and these you have executed at the current market rates applicable to each transaction. You are constantly kept aware of the fluctuating tendencies of the rates by the brokers, who telephone making offers or inquiries, and you deduce from their quotations the rates which you will apply to your own business in hand. As an example, a broker may say 'I'm a seller at the figure,' or 'I'm a buyer at three-eighths.' As a matter of fact, strictly speaking, he is neither, but he means that he is in touch with other dealers who respectively are sellers at, say, \$4.68 or buyers at \$4.68 $\frac{3}{8}$. There is no need for anyone to waste time by quoting the dollars and cents of the rate, for all are aware of it; all they refer to is the fraction unless it is the 'figure.'

As a result of the many deals you have effected you may have sold on balance much more than your original

\$5000, and you will have to purchase on the market to level up your position. You may, therefore, call up a broker who, like yourself, specialises in dollars and inform him 'I'm a buyer of \$5000 at a quarter.' If he already knows of someone who is a seller at 4.68½ he replies 'I give you at a quarter' and passes the name of the selling bank; if not, he works round the market, and maybe comes back to inform you 'I cannot manage better than one-eighth,' which you either accept or decline according to your view of the tendency of the market. You may think that you will get your price by waiting until later in the day.

Arbitrage

It may be that shortly afterwards a Paris bank comes through on the telephone and, during a staccato conversation, your colleague, the dealer who handles francs, learns that the former is a seller of dollars against francs. Possibly your colleague may have a surplus in francs which he is anxious to get rid of, or he may be willing to sell them in anticipation of purchases later in the day or in the knowledge that he can immediately re-buy them on the market at a profit. The Paris dealer gives the direct franc-dollar rate at which he will work, and your colleague, with practised skill, and perhaps with the aid of a cylinder covered with graduated scales, is working out the problem in terms of a sterling-dollar rate and a sterling-franc rate whilst he converses. If the result of his calculations shows him that he can handle the francs at a profit and give you the dollars at your figure the deal is closed on the spot and an arbitrage transaction has been effected. All this takes only a few moments, for telephone calls are expensive and of short duration, and there is no time to ponder upon the question; a dealer must be a quick thinker and a lightning calculator.

Calls used to come through from Amsterdam, from Stockholm or Copenhagen, Brussels or Zurich, or cables

from New York, Montreal, Buenos Aires, or Rio de Janeiro, making offers or giving orders. Only Berlin and Rome were missing in pre-1939 days, because their currency restrictions did not permit free dealings in the world's exchange markets.

The day passes with a mixture of 'retail' transactions, 'market' deals, and foreign arbitrage operations. All take place in a tornado of noise, dealers shouting into the telephone transmitters simultaneously in several languages. It is a nerve-racking business carried on at high speed and continuous pressure. It is miraculous therefore that so few errors occur to cause disputes with brokers and foreign banks over the multitudinous deals that are transacted in an atmosphere so unfavourable to concentration and accuracy.

Speculative Dealing

The wise operator takes care to keep his position fairly balanced; that is, he endeavours to match his sales with his purchases so that he is not gambling in exchange, for, as in any other form of hazard, the chances are fairly evenly balanced. In any case the banks frown upon the practice with its attendant risks. There is the additional reason that speculations are detrimental to the currencies which are subject to 'bear' attacks of this description, and appeals not to facilitate them are always sure of a response from the London market.

Instead of speculative gains, the dealer relies upon the legitimate profit which he secures by selling at the fractionally more favourable rate than that at which he buys. The margins are infinitesimally small as compared with those secured in mercantile trading; in fact, in large transactions the profit may be as small as six-pence per £100, but the large turnover makes the 'turn' worth while.

The Origin of 'Forward' Exchange

So far in this description of foreign exchange dealings we have considered only 'spot' transactions, that is to

say, those for immediate settlement. In the pre-1914 days of the almost universal Gold Standard there were rarely any other kinds, because merchants did not trouble to buy their exchange until the time for settlement of their debts arrived. They could quote their prices for selling and buying foreign goods in dollars, francs, or other currencies on the basis of the relative par of exchange, in the knowledge that their remittance rates could not swing more than $\frac{1}{2}$ per cent. on either side of par; in fact the margin could be much smaller still, for it was fairly easy to forecast the possible movements of the exchange according to the season. In the autumn, for example, the dollar had a tendency to increase in value because of the large demand for dollars in order to pay for the shipments of cotton and grain coming over at the finish of the harvests. At other times the rate would tend to rise above par, but, as explained in Chapter VIII, the 'gold points' limited the amplitude of the swing.

When the Gold Standard no longer obtained, this check on the movements of the exchange ceased to exist, and the rate therefore was free to move without limit at the relative pulls of supply and demand. Under such circumstances a merchant ordering goods from abroad for delivery at a future date would never know what his dollars were going to cost him, for nobody could foresee the rate which would be ruling at the time when settlement had to be made for the merchandise. It became essential, therefore, for merchants to be able to make forward contracts for foreign exchange in the same manner that cotton merchants and others in the past had been able to make forward contracts in their commodity.

How the Forward Market is maintained

A forward foreign exchange market therefore sprang up in London and elsewhere, by means of which, for instance, a buyer of American goods was enabled to fix

the rate at which he would be able to buy his dollars at a fixed future date. How, then, was this market instituted?

It is obvious that whilst there may be buyers of forward dollars there can also be sellers of forward dollars, and occasionally these may match each other. To the extent to which this occurs there is no difficulty at all in making such a market, but if there were an excess of buyers of dollars, or of sellers, somebody would have to go unsatisfied if that were the only means available. Here it is that the banks and dealers in foreign exchange are again able to assist traders. With their large resources it is easy for a bank to buy dollars and keep them, so to speak, in cold storage until the merchant has to pay for his imports. Such a process means that the bank would have to part with sterling, and in effect would make a loan of the amount to the merchant; on the other hand, the dollars which the bank simultaneously acquires would be held by it in New York until the required date, and these would act as security. In the majority of cases the sterling loan would be more expensive in interest than the earnings on dollars left in New York on deposit and the trader so accommodated would have to pay the bank a premium on his forward dollars, as compared with a spot transaction, commensurate with the difference between these two interest rates. It may sometimes, however, be the opposite way round.

If the pressure of forward dollars were in the reverse direction, that is, there are more sellers than buyers, the exchange dealers raise loans of dollars in New York; these they sell for sterling, which they hold until the maturity of the contract. When the agreed date arrives the merchant pays to the exchange dealers the dollars he had contracted to sell, who use them to discharge their dollar borrowings and thereupon pay the merchant the equivalent sterling which they hold. As to the rate of exchange this, again, depends upon the relative interest

rates in New York and London; if it is lower in New York than in London there is a tendency for the forward rate to be at a discount against spot, instead of the premium which arose under the circumstances mentioned earlier.

Forward Contracts

It should be mentioned that customers who make forward contracts with their banks are frequently required to deposit cash margins. Just as in the case of a loan, where the bank expects security to a value in excess of the loan in order to provide for possible depreciation of the cover, so the bank usually is not satisfied merely to hold the dollars or other currencies as collateral; it asks for perhaps a 10, 20, or even 25 per cent. cash margin, in case the value of the foreign money should alter to the detriment of the contract. It is easy to see that if, for instance, the customer has bought forward dollars for delivery in three months' time, and in the interim spot dollars have become cheaper, the position offers temptations to an unscrupulous person, for he has every inducement to 'side-step' his contract and make a fresh deal elsewhere at the cheaper price. Quite apart, however, from dishonesty, a customer who has made the contract and who, for perfectly legitimate reasons, is unable to fulfil it will be called upon to pay the difference between the contract price and the current selling value of the dollars. It is to provide for such a possible loss that the bank asks for a margin, and will require it to be increased should movements in the dollar rate adverse to the contract take place during its currency.

An example may perhaps make the case clearer. You, a buyer of American goods which are to be shipped in three months' time, make a contract in January with the bank whereby you purchase \$10,000 at the rate of \$4.50 per £1, for delivery during April. The bank requires, and you pay, a cash margin of 10 per cent., or,

say, £220. In February dollars have become cheaper at 4.75 and the rate therefore has moved adversely to the contract by slightly over 5 per cent., for did it not exist you could now to that extent buy more dollars for each £. The bank may require from you a further £110 margin to restore the margin to 10 per cent. on the new position; at all events, it may say that if the dollar depreciates still further you will be required to adjust matters.

Now suppose that when April arrives your American supplier, through a strike for instance, finds he cannot ship the goods, and since you are compelled to cancel his contract you will no longer require the dollars. You therefore approach the bank and explain the circumstances and ask that the forward exchange contract be closed.

The bank will render a closing statement something on the following lines:—

Sold to you	\$10,000 at 4.50 =	£2222	4	5
Bought from you	\$10,000 at 4.70 =	2127	13	2
		<hr/>		
Difference to pay		94	11	3
Margin deposited		220	0	0
		<hr/>		
Credited to your account		£125	8	9
		<hr/>		

It will be seen that the bank sells to you the dollars at the contract price and as you no longer require them, in effect you sell the \$10,000 back to the bank for what they will fetch; in the event, this turns out to be a little better than appeared likely in February. Had the current rate remained steady throughout at 4.50 there would have been no loss at all to you, and had the rate moved downwards you would have made a positive profit so far as the exchange contract is concerned, whatever may have happened to your business as a result of the American's failure to deliver your goods.

High and Low Rates

All the foregoing will have shown that whenever a foreign currency has depreciated in value against sterling, *i.e.* it has become cheaper in terms of £ s. d., the rate has risen; conversely when it has appreciated the rate has fallen. At first sight this seems paradoxical, but a moment's thought will show that, when the quotation is in terms of the foreign currency per £1, a rise in the rate denotes that more of the foreign units are necessary to purchase sterling and therefore each unit has become less valuable. And *vice versa*.

If, however, the exchange rate is expressed in terms of sterling for the unit of foreign currency the reverse of the foregoing is the case. If, for instance, one is considering Indian money, where the exchange quotation is quoted in sterling at perhaps 1s. 6d. per Rupee, an appreciation of the latter would be shown by a rise in the rate to 1s. 6½d.

A buyer of foreign exchange therefore finds it more advantageous to buy at a high rate in the case of exchange expressed in terms of the currency and at a low rate in the case where expressed in sterling. Conversely a seller prefers a low currency rate, because he has to part with less foreign money to acquire £1, and a high sterling rate, when he receives more sterling for each foreign unit.

Transfers of Exchange

There are several ways in which deliveries of foreign currencies may be made. The most common method is that adopted where the bank issues to you a draft or cheque on its agent abroad and you send the instrument to your foreign creditor in settlement of his account. An alternative way, and one often used in cases where you are aware of the name of his banker, is to ask your own bank to make a 'mail transfer' or a 'letter transfer' to the overseas bank for the credit of your friend's

account. If he is a traveller, you may instruct that he be paid 'upon his application and identification,' and you will naturally ascertain and tell him the name of the foreign bank at which he must apply.

If, however, the matter is more urgent, you will request your bank to make a 'telegraphic transfer,' and in such an event the necessary instructions will be cabled to its agent abroad. The rate at which the bank will sell you a 'T.T.,' as these transfers are colloquially called, will be somewhat less advantageous than that for a draft or mail transfer, for the foreign currency will be paid out at an earlier date. There is the additional expense of the cost of the cable unless the deal is such a large one that the bank is willing to bear it.

Speculative Attacks upon Currencies

London as the centre of the financial world was always subject to large movements of foreign funds, and it was principally to this fact that we owed our embarrassment in 1931 when the Gold Standard had to be relinquished. As these migrations of capital play havoc with our credit policy, and nullify our endeavours to keep the price-level consistent, plans to make such movements inoperative were considered and the institution of the Exchange Equalisation Account was the result.

There was another reason why the Account was instituted. Earlier in this chapter it was mentioned that speculative movements sometimes arise when 'bear' attacks against a currency are in progress. For those unfamiliar with Stock Exchange terms it may be explained that a 'bear' is a person who takes the view that a share may fall in value. If, therefore, he sells shares now which he does not possess, and arranges that he may defer delivery, he hopes to be able to buy them in more cheaply later. He thus makes a profit out of the difference, if his anticipation is realised.

In a parallel manner, the exchange speculator,

believing that the franc for example will depreciate in value, becomes a 'bear' and sells for forward delivery francs which he never will possess in the ordinary legitimate course of business, hoping to be able to buy them in at a cheaper price before the delivery date arrives.

It is obvious that sales such as these tend to accentuate the difficulties which a currency may already be experiencing. If the French are worried that an inflationary position may result in depreciation of the franc, 'bear' attacks will have the immediate effect of reducing its value abroad and will add to the embarrassment of the French authorities. The franc has been cited as an example because it was most often subjected to attack, but in similar manner sterling has occasionally been the object of 'bear' attention, and the fact that authority might swoop down upon them at inconvenient moments acted as a powerful deterrent with speculators.

The Working of the Exchange Equalisation Account

How then were these desired objects achieved by the Exchange Equalisation Account? The first necessity is to be able to dispose of adequate supplies of money, and the means of raising funds, in the form of Treasury Bills, were therefore placed at the disposal of the managers of the 'Account,' who are in fact the Bank of England. At first Parliament voted that the fund should have borrowing powers up to £150 millions, as well as some £25 millions given in cash from an old fund set up in 1925 in connection with the resumption of the Gold Standard. Later the power to borrow on Treasury Bills was increased by £200 millions, and again by a further £200 millions in 1937. The Account however had to reimburse the Bank of England in respect of a loss of £8 millions sustained under the guarantee of the Government when we vainly tried

to maintain the Gold Standard in 1931. Altogether, therefore, the Exchange Equalisation Account had at its disposal a maximum of £567 millions as a weapon with which to carry out its operations. It operated in an atmosphere of secrecy the more effectively to intervene against speculators.

The method of working is quite simple in character but highly efficient in results. When an influx of foreign funds into this country is taking place the foreigner is offering his own currency to the banks in exchange for sterling, and the effect would normally be to drive up the value of the £. Here the E.E.A. (to shorten its cumbersome title) intervenes by buying from the banks the surplus offerings of, let us assume, francs, to take a pre-War typical example. Since sales and purchases then match each other, no untoward movement in the franc-sterling rate occurs.

As the E.E.A. pays for the purchased francs it transfers the equivalent sterling to the banks, who credit the foreigners for their sales. The banks find their accounts at the Bank of England increased by the money received from the E.E.A. and in ordinary circumstances this would permit them to lend or to invest ten times the amount. The fugitive money thus would cause considerable inflation in our monetary system. The next step in the chain of events however corrects the matter, for in order to acquire pounds to replace those paid out against the francs the E.E.A. discounts a sufficient volume of Treasury Bills in the money market. This has the effect of reducing again the banks' balances at the Bank of England, for they have to transfer to the E.E.A.'s account, there, the money which they pay for the Treasury Bills.

The E.E.A. in the meantime converts the acquired francs into gold at the Bank of France, which it probably leaves there in safe custody for the time being.

The position at the banks is that they now have increased deposit or current accounts in the names of

Frenchmen balanced by an equivalent holding of Treasury Bills. These accounts remaining dormant and not being spent in the purchase of goods have no effect on the price-level here, as was mentioned in Chapter XI, although there is an apparent increase in the volume of money, much of it being left on current account. Actually, as there has been no increase in their 'cash' at the Bank of England, the banks should really reduce their investments and so reduce other deposit or current accounts by the amount of the French balances, which would result in deflation. The E.E.A. however takes other steps which enable the banks to acquire 'cash' to the extent of one-tenth of the French money, and all is regularised.

Let us now take the case where the Frenchmen, reassured as to their home position, later decide to repatriate their money from London. They offer sterling on the exchange market for francs, and if it were not for the fact that the E.E.A. now steps in as a seller of francs, which it proceeds to obtain from the Bank of France in exchange for the gold, the preponderance of demand for French currency would have an adverse effect upon sterling; as it is, the franc-sterling rate remains steady. The Frenchmen pay away their sterling balances in exchange for their purchases of francs and the funds go to the E.E.A. as the sellers of the currency, with the result that the banks' balances at the Bank of England are depleted to the same extent. This would in the ordinary way require a drastic deflation by the banks, to the extent of ten times the amount, were it not for the fact that the E.E.A. buys back the Treasury Bills and so puts the banks in funds again at the Bank of England.

It will be realised how delicate is the control occasioned by the operations of the E.E.A., and how it has smoothed out untoward movements in the exchange rates as well as changes in the price-level which would otherwise have been caused by the drastic variations in the credit

structure. It is not the function of the E.E.A., however, to prevent movements in the exchange rates which are attributable to long-term causes, such as an adverse or a too-favourable balance of trade. In such events, it allows the rates gently to find their new levels if the cause cannot be remedied.

The E.E.A. has a very efficient system of ascertaining whether exchange offerings are due to movements of fugitive capital or to the more deep-seated causes just mentioned. The method however is secret and therefore cannot be discussed here.

As to 'bear' attacks, the E.E.A. is so swift and powerful that the would-be operator is a bold person if he takes a large-scale chance in the face of probable intervention by the authorities. It is far too risky, and if he persisted he could easily be broken as a result of his temerity.

The Exchange Equalisation Account as an institution has probably come to stay, at all events so long as we work upon a managed-currency basis. Even in the unlikely event of a future reversion to a Gold Standard, it is probable that for a long time the semi-automatic working will have to be aided by a modification of the E.E.A. It has fulfilled an excellent rôle, and the method has been adopted in principle and practice by other countries. Owing, however, to the rigid and direct control instituted during the present war, and the abrogation of free foreign exchange, the functions of the E.E.A. have become unnecessary and are therefore suspended for the time being. There seems little reason to doubt that if and when exchange business is released from control, the E.E.A. will of necessity be reinstated in order to protect sterling as in pre-1939 days.

As to the general information conveyed in this chapter, the reader may be reminded that it relates to pre-World War conditions. In the final chapter will be indicated the momentous changes that have had to be effected in the foreign exchange market for the national protection since 1939.

Chapter XVI

EFFECTS OF THE SECOND WORLD WAR

SOME authorities maintain that when so many countries, including our own, were forced off gold in 1931, a chain of circumstances was started which eventually led to the outbreak of war in 1939. To the extent that the resulting chaos and misery in Germany made it so much easier for Hitler to obtain power there is a strong case to be made out for this thesis, so that a brief account of pre-War financial developments in Germany is not out of place as an introduction to this chapter.

Up to 1931 a gradually increasing desire on the part of the victors to mitigate the alleged oppressive financial effects of the peace treaties had successively lightened the reparation arrangements and after some time had led other countries, particularly the U.S.A. and Great Britain, to grant extensive financial assistance to Germany. This was mostly given by way of Acceptance Credits, which should have been utilised to finance foreign trade in the manner described in Chapter V, but in fact were not. Instead, the funds raised in New York, London and other centres by the discount of the acceptances granted, as well as by means of ordinary loans, were partly utilised to pay reparations, which chiefly went to France and to some extent to America, and partly to rebuild or reconstruct German cities and to create other internal fixed assets, none of which should ever have been permitted or undertaken against such foreign finance.

When a financial crisis arose in 1931, through over-expansion on the part of some of the German banks, the Germans found it impossible to repay the accommodation since the money was not represented by shipments of goods, which are ordinarily self-liquidating, but instead by bricks and mortar in Germany and, to the extent to which it had been used to pay reparations, by

nothing at all. Incidentally, it was due to the circumstance that France had largely left her German reparations in London that we were forced off the Gold Standard in 1931, for she hurriedly drew off gold when our own circumstances in that year caused her to take fright, until we were virtually denuded of the metal.

Blocked Accounts

Germany clearly was unable to repay us, nor did she ever pay any further reparations, because to some extent at least the growing sentiment in favour of protection and economic self-sufficiency everywhere tended to shut out her goods by which alone she could discharge her obligations. To a much greater extent, however, it was due to her resentment over the terms of the peace treaties. Germany therefore decided to default in respect of nearly all her long-term external obligations, both State and Municipal, and her short-term liabilities as represented by financial credits granted by foreign banks and other institutions. Moreover she blocked all non-German balances with her banks and moneys owing by her nationals to external creditors. Thereafter no foreign exchange transaction in respect of any of these old outstandings was permitted except by specific licence, which would only be granted for rigidly defined purposes by the authority set up. All new transactions, however, were unrestricted, and banks could therefore acquire fresh Mark balances and dispose of them without hindrance.

The Standstill Agreement

It has been calculated that there was owing by Germany to the outside world some M.6000 millions in short-term money when she defaulted in 1931.

Negotiations took place between German bankers and those of other nations in the full expectation, by the latter at all events, that after a period of recuperation

the debtor country would begin to honour and pay off her external short-term debt. After a year or two it became clear that she had no intention whatever of restricting imports and using the exports to pay off her blocked liabilities. The 'Standstill' agreement made by the bankers, and renewed periodically, became the instrument recording the results of the struggle between the negotiators, the one side endeavouring to get as much, and the other to give as little, as possible. The Germans, having the whip hand, successfully achieved their object, and what they did concede was on terms highly favourable to themselves.

Trade Clearing System

The Trade Clearing System as practised by Germany achieved a high degree of success, particularly with the Balkan countries. The method, as evolved by the astute Dr Schacht, was to make enormous purchases of grain, foodstuffs, ores, or other essential imports, the payments for which, in Marks, were placed upon Clearing Account, the funds thereafter only being released to pay for German goods exported to the other country involved. Since, however, the Germans often found it 'inconvenient' to supply the goods specially wanted by the other country, the latter had to take material which it did not really require in order to reduce the formidable balance on Clearing Account which Germany had already built up by her acquisitions of valuable imports. Such positions gave rise to the gibes that Germany first took Balkan wheat and then paid for it by millions of pounds worth of aspirin and mouth-organs. When in fact the exporting countries found that their grain and foodstuffs were actually being resold by Germany to other nations, in exchange for armaments and warlike essentials, they had a distinct grievance over the transactions. In such manner did Germany build up reserves of war material.

Other Trade Clearing arrangements were in force between ourselves and various nations, such as Roumania,

Spain, Turkey, and others, and formed a network of relationships which were antagonistic to the old ideal of complete freedom of international trade and foreign exchange. Additionally there were trade pacts which disturbed the former course of business between the two parties and the rest of the world. Restrictive controls on the part of various governments affecting the imports into their several countries were also largely in vogue, and were operated by the institution of licensing systems for the allocation of exchange to selected types of merchandise and raw materials. Amongst others, the South American countries, Japan, and even New Zealand adopted the method.

Hence the world foreign exchange market was obstructed and arbitrage transactions were hindered on every hand; the old protectionist impediments were aided and reinforced by direct interferences in the movements of goods and services. In place of the old ideal of each nation producing, for the benefit of humanity, what she was best fitted by nature to develop, we found selfish aims of *amour propre* and megalomania breeding ill-feeling and wars of conquest, and resulting in a lowered standard of living all over the world.

When war broke out other countries, including our own, found themselves compelled to adopt many of these same measures to protect their reserves of gold and foreign exchange, and the German pattern was largely followed, with varying degrees of success.

Exchange Control

After Munich, in 1938, the authorities evolved comprehensive financial measures which could be brought into instant operation if the need arose. The resultant scheme was therefore ready, and sealed orders were in the hands of the banks, when war was declared in 1939. Thus there came into force immediately the Defence (Finance) Regulations 1939, which instituted a drastic system of Exchange Control. Since then there have

been many additions and modifications, and in 1947 the Exchange Control Act was passed, as it was all too clear that the need for control was still with us, and that the country's transactions with the outside world could not be indefinitely governed by temporary legislation.

Foreign Exchange requisitioned

The Bank of England, acting for the Treasury, was made the sole holder of all the principal foreign currencies and of gold. Every possessor of dollars, francs, kroner, etc., was bound to declare his holdings and to sell them to the Treasury through the banks at the official rates of exchange promulgated. The Government did not intend to allow the national holdings of foreign currency to be frittered away, as in the First World War, in the purchase of luxury articles; nor were unpatriotic people to be allowed to export their capital, by buying dollars for example. All our resources abroad were to be dedicated to war purposes. This direct control over Foreign Exchange naturally rendered unnecessary the function of the Exchange Equalisation Account described in Chapter XV, and except as a holding account for the national gold stocks it passed out of use.

All applicants for foreign exchange had to complete form (E) setting out the reason for the purchase. In well-defined cases the banks, acting on behalf of the Bank of England, were given power to approve the forms and sell the currency, but in others applications had to be sanctioned by the Bank of England itself. In practice the important banks, specially authorised by the Treasury, held upon their accounts abroad the national stocks of foreign currencies in their own names, acting however as sub-agents of the Bank of England and therefore of the Treasury. Since the banks were no longer dealers for their own account, and therefore were not entitled to the profit entailed in the difference between the official buying and selling rates, they were authorised to charge a commission to compensate them

for their work in putting their existing intricate organisation at the disposal of the State.

In January 1947 there was a relaxation from the war-time arrangement under which foreign currencies held by the banks on their accounts abroad belonged either to the Bank of England or to certain customers officially permitted to retain 'foreign' currency. To replace the Bank of England currency deposits the banks were allowed to purchase their own stocks of foreign currencies, but differences between total sales and total purchases have to be accounted for to the Bank of England daily, and, of course, all transactions are subject to the Exchange Control Act.

Control of Sterling

All banking accounts in the sterling area are designated resident or non-resident according to the domicile (not the nationality) of the holder. Non-residents are those domiciled outside the sterling area, which consisted of Great Britain and the Empire, excluding Canada and Hong Kong for special reasons. During the War many territories were added, *e.g.* the Free French Territories and the Belgian Congo, but as the allied countries were liberated the sterling area shrank again. The present name for the sterling area is the Scheduled Territories, which comprise the British Empire (except Canada), British Mandated Territories, British Protectorates and Protected States, Burma, Iraq and Iceland.

The Exchange Control Act prohibits transfers from resident to non-resident accounts unless authorised by the Bank of England or the banks acting as its agents, and to obtain this approval a form (E1) has to be completed which is similar to form E for foreign currency. Thus, unless specially authorised, it is not permissible for residents to give cheques to, or make transfers to the accounts of, non-residents. In addition to such authorised transfers from residents' accounts non-resident accounts can also be fed without formality from other non-

resident accounts of the same country. Thus an American account can be fed from another American account, but not from a Belgian account. They can be debited without formality to pay residents of the Scheduled Territories or other non-resident accounts of their own country. Two significant features should be noted: the first that our financial relations with the rest of the world were placed on a bilateral basis, which, as will be explained later, has been subsequently modified: the second is that to credit a non-resident account is in effect to transfer the money abroad, as it can be remitted to the account holder in his own country without further formality. That is why banks are so careful to insist on an E1 being approved before accepting funds for the accounts of non-residents.

Control of Imports

Before goods can be imported a licence has to be obtained from the Board of Trade, and these are not issued unless the goods are necessary and it is considered that the country can afford the foreign exchange which they will cost. Furthermore, whenever the Control (*i.e.* the Bank of England or the authorised British banks acting within the scope of their authority) give permission, on the strength of the licence, for sales of foreign currency or transfers of sterling to non-resident accounts, to enable a resident here to purchase foreign goods, they require to be satisfied that the goods have been or will be imported. The importer therefore has to produce in advance or within a reasonable time thereafter a certified copy of the 'Customs Entry' as proof of the genuineness of the transaction.

Control of Exports

One obvious loophole through the Control was to export goods and leave the proceeds abroad instead of having them remitted back to the U.K. The CD3 procedure by which exporters' bankers have to certify

that proceeds have been received by an appropriate method, and within a certain time, effectually prevents such infringements, as control is achieved by the Bank of England and H.M. Customs working together.

Local Controls

If anyone in the U.K. had or should have an idea of by-passing the Control here by transferring funds outside the Scheduled Territories via one of the other territories, *e.g.* New Zealand, he found, and will still find, that each Territory has its own Local Control which works in close conjunction with the Bank of England.

Securities Control

Besides foreign exchange and transfers of sterling, securities have also to be controlled or capital could be transferred outside the Scheduled Territories by transfers of ownership. Non-resident holders of sterling securities can sell them only in order to reinvest the proceeds. They cannot have the proceeds of sales remitted to them, but they may receive the interest and the proceeds of normal repayments of capital, *e.g.* drawn bonds. One of the few big differences between the Defence (Finance) Regulations and the present Exchange Control Act is that, under the latter, bearer and certain other securities have to be deposited with a bank.

Treatment of Non-Residents

Our desperate need to conserve foreign exchange and to prevent an outflow of capital made it necessary for us to impose the restriction on non-residents repatriating the sale proceeds of their capital assets here, but they have all along been allowed to have the income due to them. Similarly rents have always been treated as remittable funds. Even legacies, which in many cases are capital items, have been allowed to go to non-resident beneficiaries. Anyone who has had actual day-to-day contact with the Exchange Control authorities

will agree that every effort has been made to ensure that the Regulations and the Act are administered in a considerate manner, fair to all parties concerned. Right from the early days it has been possible to give effect to contractual obligations legally undertaken, and, generally speaking, the fault has been not that we have been niggardly to non-residents or to British residents wishing to send money abroad for various reasons, but over-generous in view of our need to conserve foreign exchange.

Compensation Deals

Many people here seem to think that so long as they do not apply for foreign exchange, or send their own cheques outside the U.K. in exchange for desired goods, they can settle matters in other ways and no one will mind. Usually they are mistaken in this belief. For example, an Englishman finds out that an American owes someone here some money, and, since he is keen on sending his daughter, a G.I. bride, a twenty-first-birthday present, or buying his wife some article in New York, not procurable here, he offers to pay the debt due here himself in exchange for the payment to be made on his behalf in New York. When it is pointed out to him that this is an infringement of the Act he answers indignantly that 'no money has left the country.' What he overlooks is that, (a) if he had kept out of the picture, the American would have sent dollars to pay his debt, and we should have been that much better off, (b) his application to send a present or to buy the nylons was refused in the first place because our dollar shortage is so grave that they cannot be used for such purposes, and (c) if such practices became widespread the whole apparatus of Exchange Control would fall to pieces. Similarly it is an offence to borrow from a non-resident except with Bank of England permission, which is rarely given. It is a safe rule to assume that if an application to buy foreign exchange or to transfer sterling is refused,

then any ingenious way round is almost certainly an infringement.

Bretton Woods

Whilst the war was still being waged many people seemed to think that as soon as it was over the Defence (Finance) Regulations would be scrapped: so far as they thought about the subject at all they regarded the regulations as a disagreeable necessity like the blackout, for which there would no longer be a need in peace-time. The first jolt to such complacency was President Truman's announcement of the end of Lease-Lend: in fact it is probably true to say that what first made the people of Britain 'dollar-conscious' was the Food Minister's statement that dried eggs would no longer be available owing to our shortage of U.S. dollars.

Financial authorities all over the world were, however, well aware of the chaotic condition in which the world would be when the war ended, and schemes evolved by the late Lord Keynes and Mr Harry D. White were put forward for discussion by the British and U.S. Treasuries as early as 1943. Both schemes were primarily designed to facilitate foreign trade settlements, and were the forerunners of the plan actually adopted later.

In 1944 the United Nations Monetary and Financial Conference met at Bretton Woods, in the U.S.A., and, as a result of their deliberations, an International Monetary Fund and an International Bank for Reconstruction and Development were established. The objects of the Fund were to stabilise exchanges, thus eliminating unilateral devaluations, and to free world trade from the restrictions which had characterised the pre-War years. The old ideal of complete freedom of international trade and foreign exchange had suffered from the growing number of closed exchange systems, and the Bretton Woods signatories, especially the United States representatives, hoped to devise a scheme that would enable the nations of the world to dispense with

exchange restrictions and bilateral payments agreements, and to get world trade back to a multilateral basis.

The Fund is composed of quotas from the participating countries consisting of 75 per cent. of their own currencies and 25 per cent. of gold, provided their gold holdings are sufficient. If a member has recourse to the Fund to buy currency of another member, the Fund holds more of the buyer's currency and less of that of the country whose currency is purchased. If a country persistently buys other currencies the Fund will hold more and more of its currency, so it is laid down that the Fund cannot hold more of one country's currency than double its quota less its gold subscription. It will take some time for this position to arise, since a member cannot call upon the Fund to such an extent that in any one year the Fund's holding of the member's currency increases by more than 25 per cent. of its quota.

The Agreed Rates of exchange may only be varied with the Fund's consent, but permission may be sought to effect a devaluation of a country's currency if this becomes necessary to correct 'a fundamental disequilibrium.' On the other hand, if there is a great demand for a particular currency, and recommendations to the country concerned by the Fund fail to alleviate the situation, then as a last resort there may be a formal declaration that it is a 'scarce currency,' and the Fund may proceed to ration it among the other members: furthermore they may then 'temporarily impose limitations on the freedom of exchange operations in the scarce currency.' The suggestion here is that the other members would refuse to provide the scarce currency to their nationals and thus place an embargo on imports from the scarce currency country.

The Fund was to be used only to assist in financing 'current transactions' as opposed to capital transfers, and it was realised that during a transitional period exchange restrictions of various kinds would have to continue. The underlying intention was to free trade

and to iron out excessive and violent movements in rates of exchange by financing temporary differences in current trade between member countries; but events soon proved that six years of total war had led to a chronic state of fundamental disequilibrium. France, for instance, has had to devalue the franc several times since the liberation, and although the Fund expressed its displeasure at the somewhat disingenuous method adopted at the second devaluation, viz. the institution of multiple exchange rates, the French persisted in operating a system in which two rates of exchange were quoted. France was told that she could not expect assistance from the Fund, but since the great call is for dollars, and since the nations receiving Marshall aid have all been told that they may not for the time being take further dollar advances from the Fund, the reprisal turned out to be merely an empty gesture. The unfortunate affair, which was due to a too hasty fixing of parities between the participating countries in the first place, was therefore an undoubted rebuff for the Fund, and the principle of orderly and agreed alterations of existing exchange rates.

Later developments have overshadowed the Fund but extensive use has been made of it, and in March 1949 the total of currency purchases by member countries was almost \$700,000,000 since the Fund began exchange operations on 1st March 1947.

The Bretton Woods signatories realised that measures to deal with 'current trade transactions' and temporary differences in the Balance of Payments position in various countries would not be sufficient in themselves to meet the post-War situation, and the Bank for Reconstruction and Development was also set up to guarantee or make loans to member governments, cities and large private concerns. In view of the fate of loans made by private investors after 1918 it was realised that, in the absence of some such powerful backer, borrowers, however deserving, would find it quite impossible to

raise reconstruction loans at all, let alone on reasonable terms.

There is a not uninfluential school of economic thought which adopts the defeatist attitude that world trade can never attain its old freedom and volume. The adherents point to the fact that the primary producer countries such as Australia and Argentina are tending to become also manufacturing countries, and claim that we in the U.K. cannot in future expect to rely to the same extent on world trade. They pin their faith to bilateral agreements, bulk buying and selling, permanently controlled exchanges, import and export licences, and other expedients which are essentially elaborations on the primitive barter system. Because the gold standard system was expected to work under impossible conditions between the wars, and eventually failed, they regard with deep suspicion any international system of exchange connected with gold.

As has been indicated, there was opposition to the Bretton Woods Agreements, but supporters of the multilateral ideal can congratulate the signatories on their achievement, in spite of the fact that they failed to realise the magnitude of the problems with which the post-War world was to be faced, due to a fundamental economic maladjustment.

Bilateral Agreements

Bilateral Payments Agreements were made during the War, when normal trade was impossible, to meet the threat to our overseas purchasing power arising from our lopsided payments position. These Agreements provided a means acceptable to the foreign governments concerned, whereby goods and services were supplied to us on credit in the form of sterling deposits. As these Agreements came up for revision after the War, the negotiators were faced with the problem of dealing with

these sterling balances and, at the same time, establishing closer equilibrium in the current payments position. Different methods have been adopted from time to time to settle balances: for instance, in some cases the U.K. has agreed to provide gold when a particular country's holding of sterling goes over a certain figure. If this turns out to be unsatisfactory, in that our purchases have exceeded our sales and a serious gold loss has ensued, we seek, when renewing the Agreement, to persuade the country concerned to hold a larger amount of sterling or to capitalise the excess in some form. These bilateral arrangements have served, and are still serving, a useful purpose, but compared with multilateralism they obviously limit the volume of trade. As matters stand we cannot buy as much as we should like from Belgium and Canada, because they cannot afford to pile up inconvertible sterling; but if they could use the sterling to pay for their own imports from, say, U.S.A. or Iran, as was the case before the War, it would be to everyone's advantage.

It cannot be too strongly emphasised that this country depends more than any other on international trade. We are not self-supporting, and it is essential therefore to buy our necessary foodstuffs and raw materials with the proceeds of our coal and our manufactured goods, such as textiles and machinery. Furthermore a large income is derived by the U.K. from so-called invisible exports, which include freights on goods carried by British ships and banking and insurance earnings.

Hard and Soft Currencies

Before going more fully into our post-War balance of payment difficulties it will be as well to outline what is meant by hard and soft currencies. The explanation given by the chairman of Lloyds Bank, in January 1947, is hard to improve:

'Before the war, doubtless, the dollar became known as a "hard" currency in virtue of its convertibility into gold and therefore into all other currencies; this is still, of course, an important characteristic of a "hard" currency to-day, but what is perhaps even more significant in present circumstances is the capacity of the country in question to supply required goods. In this connotation a "hard" currency country is one which (a) has the goods we need; (b) does not want to the same extent the goods we are able to export; and (c) is not prepared to extend credit beyond a defined limit. It is for these reasons, rather than for convertibility into gold or dollars, that the Swedish krona is "hard" from our point of view, whereas the Danish krone is not. Denmark is a willing buyer of the goods we are able to supply and in return for part of them she sends us dairy produce which is just as important for our economy as Swedish timber; but for her purchases from us in excess of her exports to us she can only pay us in kroner, which are not convertible into dollars. Sweden, on the other hand, is not prepared to increase her shipments of timber to us unless we can offer more of the goods she requires, in particular coal.'

It follows from this that a currency may be hard to-day and not so hard in six months time, and this uncertainty makes trading very difficult for British merchants who did a thriving business before the War in buying goods in one foreign country and selling them in another. This 'entrepôt' trade, as it is called, brought in a useful income in the past, and throughout the War the Bank of England permitted and encouraged it so long as this country both paid and received U.S. dollars. After the War, merchants began to ask their bankers to obtain Bank of England permission for transactions which promised them a handsome profit, but involved payment in a hard-currency and settlement from a soft-currency country. They were genuinely amazed to receive a flat refusal, and would point out indignantly the profit that would accrue to the U.K. The banker's task was then to explain that although the individual received a profit, this country would have had, say, to part with scarce U.S. dollars and to receive French francs or Italian lire, of which we already

held more than we required, and which were liable to sudden devaluation.

Overseas Investments

As a result of the War our income from overseas investments was greatly reduced, for the capital had been spent to pay for essential imports and services. The seriousness of the position will be apparent from the 1938 Balance of Trade figures. Our exports and re-exports amounted to £533 millions and total imports to £835 millions, but we had no cause for alarm because the net receipts from Interest, Profits and Dividends amounted to £175 millions, whilst other invisible exports reduced the gap to some £70 millions. In 1947 the *net* investment figure was only £47 millions, whereas the cost of imports was £1541 millions. Before the War our overseas investments paid for about one-quarter of our imports, but in 1947 for only one-tenth.

Anglo-American Loan Agreement

So great was our need for U.S. dollars that we found it necessary to ask the U.S.A. to grant us a loan, and the Agreement was ratified by the U.S.A. in July 1946. It was for \$3750 millions at 2 per cent. and was expected to last for 3/5 years: we were not required to begin repayments until 1951. Certain conditions were attached, the most important of which was that so far as 'current transactions' were concerned sterling was to be a convertible currency from July 1947. We were also required to take steps to reduce or fund the so-called Sterling Balances.

Sterling Balances

To explain this term it is necessary to remind the reader that prior to 1914 London was the recognised financial capital of the world, and other countries,

specially the Empire countries and the primary producer countries like Argentina, kept sterling balances in London permanently. Sterling was not only required to pay for British goods and services, but was the most useful world currency to hold. During the last war our imports, of course, greatly exceeded our exports, but our credit remained good and countries like India, Egypt and the Argentine continued to be willing to receive additions to their sterling balances in payment for our imports from them. However the end of the War found us with these sterling balances in a liquid form enormously increased. The figure is said to amount to well over £3000 millions.

The Treasury had perforce to 'block' them and, as explained earlier, agreements are entered into or renewed with the countries concerned by which a proportion of the blocked balances are released to be used, either to make payments in this country, *e.g.* to pay for exports, or even to be exchanged for hard currencies. This is the explanation of the term 'unrequited exports.' Instead of receiving foreign currency for our exports, which can be used for necessary imports, the exports are exchanged for these old debts, thus bringing home vividly what an expensive luxury war is. The term is also used when a country with a hard currency finds itself selling to a soft-currency country and piling up balances of the soft inconvertible currency instead of receiving goods or convertible currency in return. Countries which have these large sterling balances with us tend to obtain a larger proportion of goods from the U.K. than they otherwise would, and the U.S.A. views the position with a certain uneasiness. It is beyond the scope of this book to discuss the ethics of repaying a debt to, say, Egypt, which was incurred in part in saving Egypt from invasion, but there is no doubt that the sooner these huge liquid balances are written down or funded the sooner the U.K. will reach a stage of equilibrium in its trading position.

Breakdown of Convertibility

In February 1947 the Bank of England began to prepare for the following July, when sterling due to non-residents in respect of current transactions was to be convertible into other currencies. This was done by allowing certain foreign banks to maintain 'transferable' sterling accounts with London banks, and, for the first time since 1940, the bilateral system, under which sterling belonging to non-residents was available only to persons resident in the same country and to residents in the Sterling Area, was modified. It was intended that Transferable Accounts should be used for current transactions only, and some means had to be found to ensure the fulfilment of this condition. For practical purposes the movement of funds between Transferable Accounts is supervised by the monetary authorities in the countries concerned. Only a limited number of countries were placed in the 'transferable' group, and one of the Bank of England regulations permitted transfers from a transferable account to an American account. Since American sterling accounts have always been convertible into U.S. dollars, and since there was world-wide scarcity of dollars, it surprised few London bankers when this premature attempt to make sterling a convertible currency lasted only a few weeks.

In August 1947 transfers to American accounts from Transferable Accounts were stopped, as the drain on our dollar and gold reserves had proceeded at such a frightening rate that the Government had no alternative but to suspend the arrangement, which had been one of the conditions under which the U.S.A. had granted the loan. During 1947 our gold and dollar holdings decreased by £152 millions, almost a quarter of the total reserve.

Transferable accounts continue to function and are an important step along the road back to full convertibility and a world-wide system of multilateral trade. Goods bought by Holland from Italy can, for instance, be paid

for from a Dutch transferable account in London, provided Dutch and Italian authorities agree, whereas until the introduction of this system the Bank of England insisted that non-residents could have their funds remitted to their own country but not to a third country. The ice has been broken and, so far as Europe and the Scheduled Territories are concerned, London is once again becoming the place of settlement and the chief international banking centre.

The Terms of Trade

Canada had also granted the U.K. a loan: it was for \$1250 millions, and like the U.S. loan had been drawn upon for large sums in a much shorter period than had been anticipated. Apart from the fact that European recovery was taking longer than had been expected, and that the necessity to purchase foodstuffs and raw materials from the Western Hemisphere caused a world-wide scramble for dollars, the terms of trade had moved against us. In other words, our imports had become dearer whilst the value of our exports had not risen correspondingly. Primary products, particularly food, had become dearer in terms of manufactured goods, so that more of our textiles and machinery were required to pay for imports of grain and meat than before the War. The importance of this shift in prices to our balance of payments with the rest of the world is brought out by the statement in the Economic Survey for 1949, that a movement of only 5 per cent. in the terms of trade would change the balance on current account by some £100 millions a year.

The Marshall Plan

In the summer of 1947 Europe, and especially Western Europe, faced a grim future. Budgets were unbalanced, inflation was raising prices with consequent grave industrial unrest, peoples especially in France and Italy had begun to lose faith in their national currencies,

countries were importing more than they could afford to pay for by their exports, and Germany, which had been the most important economic unit on the Continent, was split up and so utterly disorganised and apathetic that U.S. and U.K. taxpayers were having to pay millions just to keep the Germans alive. So far as the U.K. and the Sterling Area were concerned, the U.S. and Canadian loans had been largely used up in about a quarter of the time expected, and one of the conditions on which the U.S. loan had been granted had not been fulfilled. The U.K. had made an honest attempt to do so, but the chronic state of disequilibrium all over the world made the failure of a premature attempt to make current sterling convertible inevitable. The Anglo-American dollar credit was used up in 19½ months, whereas it had been expected to last for 3-5 years.

Certain foreign countries appear to have misused the transferable accounts system to turn their sterling holdings into U.S. dollars in July 1947, and this and other factors caused our gold and dollar holdings, which were a reserve for the whole Sterling Area, to decrease to an alarmingly low figure. With so many other countries in the same position the danger was that a general cut in imports, due to a lack of foreign exchange, would lead rapidly to such a contraction of international trade that a vicious spiral would be started, the end of which would have been unemployment on a vast scale and a disastrous world-wide lowering of the standard of living.

The one bright spot was the suggestion made by Mr Marshall, then U.S. Secretary of State, in June 1947, that further aid might be forthcoming if European nations made plans for co-operation, so that in a limited period they could once more stand on their own feet. The British Government responded at once, and in July sixteen nations started preliminary talks in Paris. By September an estimate had been agreed to unanimously, and in December the U.S. Congress had been asked to approve a four-year programme involving an expenditure

of £4250 millions. On 3rd April the Bill was signed by President Truman, authorising £1325 millions for twelve months' assistance.

The aid could be provided on a cash, credit, or grant basis, or in return for materials for stock piling, of which the U.S.A. happened to be short. Where goods and services are made available on a grant basis the beneficiary nation has to place the equivalent on a special account in its own currency. After approval of the Economic Co-operation Administration in the U.S.A. these funds are to be used within the country concerned for such purposes as monetary stabilisation, reduction of National Debt, and development of resources. In other words, the individual firms and citizens do not get Marshall goods free, but have to pay their own Governments, who can use the funds in the ways indicated if the E.C.A. agrees that the money should be so spent. The U.S. Administrator is understood to have accepted the principle that grants should be used for meeting current requirements, whereas loans will be made for such purposes as increasing a country's productive capacity. Loans would also be appropriate in cases where countries are unable to obtain dollars despite the fact that their foreign trade is in balance.

Dollar Offshore Purchases

One of the most important and significant provisions was that which permitted U.S. dollars to be used by Marshall countries to purchase goods in non-participating countries. Only goods in short supply in the U.S.A. could be so purchased, and if the U.S.A. declares a product to be 'surplus' it can no longer be purchased elsewhere with 'offshore' dollars. This arrangement is one more sign of the anxiety of the U.S.A. to encourage multilateral trade: Canada, for instance, is short of U.S. dollars, and this provision enables her to sell her products to Europe, but still purchase essential imports from the U.S.A. Since, however, U.S. taxpayers pay

large sums to support agricultural prices, a situation may easily arise in which they ask why agricultural products cannot be used for Marshall aid instead of their having to find still more offshore U.S. dollars for Marshall countries. Anticipating this objection in the case of wheat, the E.C.A. announced in April 1949 that no further U.S. dollars will be provided to pay for Canadian wheat.

Marshall aid aims at encouraging countries whose economy is still sick to put their affairs in order, restore their external balance of trade, and so hasten the day when world currencies can once again become freely convertible. To show what a help it has already been to the U.K. in its first year's operations, it is only necessary to mention that it is covering approximately the whole dollar deficit of the Scheduled Territories.

O.E.E.C.

The Organisation for European Economic Co-operation—set up in Paris in accordance with Mr Marshall's suggestion—was essentially multilateral in conception, but has proved rather disappointing so far in this respect. In the charter of the Organisation were articles pledging the signatories to develop production to the fullest extent; foreign trade was also to be expanded; there was to be the maximum possible exchange of goods and services; economic links were to be strengthened by suitable methods, including the establishment of Customs Unions, free trade areas, etc.; tariff barriers were to be lowered; currency stability was to be maintained and internal finances put in order.

The 16 European countries prepare plans for future economic development and the task of the O.E.E.C. is to suggest revisions so that overlapping and unnecessary competition can be avoided. Eventually it is hoped that an agreed, comprehensive programme covering internal finance, foreign trade and investment policy will emerge before Marshall aid ends.

Intra-European Payments Plan

In the autumn of 1948 an Intra-European Payments Plan was introduced to overcome some of the difficulties which were preventing the expansion of trade between the O.E.E.C. countries. Agreements were made which enabled countries with deficits to continue to trade with other participating countries despite a trade deficit. For instance, some of these countries are short of sterling and the U.K. has made substantial sterling grants: on the other hand the U.K. has received credits from other countries. To this extent the agreement introduced a certain amount of multilateralism in the trade between the O.E.E.C. countries.

Until firm steps are taken to put internal and external finances in order by certain European countries—and this almost certainly involves further devaluation to more realistic rates of exchange—proposals to make the O.E.E.C. currencies convertible with each other will be coldly received by those of their neighbours whose finances are in a healthier condition. In the absence of convertibility trade must continue to be largely bilateral and this sets a limit on expansion.

Having considered some of the outstanding happenings and problems affecting the country's external trade, we must devote a few pages to a very brief commentary on the course of monetary and economic events on the home front.

Interest Rates

At the end of 1932 the Bank Rate had fallen to 2 per cent. At this figure it remained for seven years, until in August 1939, when war appeared imminent, the Bank of England raised it to 4 per cent.; but the authorities decided that money rates were not going to be allowed to soar to the detriment of the national finances as in the

First World War. A month later the rate dropped to 3 per cent. and in October 1939 to 2 per cent., at which it has remained ever since.

In 1946 the Treasury embarked on a campaign to reduce the long-term rate of interest from 3 per cent. to $2\frac{1}{2}$ per cent. by forcing up prices of gilt-edged securities. At first this ultra-cheap money policy appeared to have succeeded, but in view of the existing inflation, which physical controls, such as rationing and allocation of raw materials, were keeping in check with difficulty, the wisdom of this policy, which aimed at making Government borrowing cheap, seemed questionable. The big Government purchases of securities caused a large expansion of credit and a huge increase in banks' deposits. Such a state of affairs was scarcely compatible with the obvious need to check inflation, encourage individual savings and reduce consumer spending and, much to the satisfaction of informed opinion, the rate for long-term Government borrowing had returned to 3 per cent. by the beginning of 1947.

Some economists would like to see more use made of the rate of interest in the working of our economy. For instance in present conditions a moderate increase could be expected to encourage private saving and to discourage capital expenditure on projects desirable in themselves, but beyond our present means, when all our energies should be devoted to building up an export trade which will eliminate the need to rely on American charity. At present rates, instead of private saving checking inflation and financing industry, the individual's power to spend is checked by Budget surpluses, and in effect the Government does our saving for us compulsorily; but taxpayers have very little say as to the subsequent investment. This is probably not a deliberate policy but merely the result of high taxation, which makes individual saving impossible, which in turn requires a Budget surplus only obtainable by high taxation.

Inflation

As our war production effort developed, after September 1939, the Government prepared to take steps to prevent undue inflation. The ratio of purchasing power to goods was rapidly increasing, and the Chancellor of the Exchequer increased the income-tax rate successively from 5s. 6d. to 10s., whilst surtax was finally raised to such heights that a net income of £5000 was possible only to those possessing a gross income of £66,000 per annum. At the same time the lowering of the level of taxable incomes by the Chancellor and collection by deduction from wages and salaries brought into the net millions of people who had never been subject before to income tax. Again, the war savings movement strove to persuade all classes to buy National Savings Certificates and War Bonds. Even a combination of both methods was essayed when the Chancellor instituted 'post-war credits' to make less unpalatable a more severe budget: purchase tax and drastically increased indirect taxation from excise and other commodities were imposed. All these methods combined to drain off purchasing power and blunt its impact with the dwindling volume of goods remaining for civilian consumption, so restraining the inflationary processes to the greatest extent possible.

Despite these measures the gap was never anything like closed between war expenditure and withdrawal of purchasing power, and prices were bound to show some increase. This naturally gave rise to demands for war bonuses to meet the increased cost of living.

A few figures will illustrate the inordinate effect on prices occasioned by rises in wages. Let us take the hypothesis that, in time of strenuous war production, £10,000 millions per annum is the national expenditure on production. Payments to that amount will, therefore, be distributed as income, via wages, salaries, profits, etc. Let us further imagine that 80 per cent. of the whole output is required for the Armed Forces. Clearly then

the working community will require only £2000 millions spending power to acquire all that the national exigency can permit it to consume. As a body, the population cannot spend more than £2000 millions out of their total income of £10,000 millions since, *ex hypothesi*, the goods are not available, and they require no more than the smaller amount to purchase exactly their share. From this it follows that the population can support taxation and/or compulsory loan subscription up to 16s. in the £ of its aggregate income, however the impost be raised in detail. If the £2000 millions is insufficient to exist upon, then the allocation between civilians and the Services is wrong and not the taxation. The latter theoretically can be fixed at that percentage of the whole production decided upon for civilian consumption.

Now let us assume that taxation is imposed at the effective overall rate of 8s. in the £ only, and in the absence of compulsion, moral or otherwise, subscriptions to war loans and savings are made to the extent of no more than £2000 millions. This will leave £4000 millions in the hands of the public which will compete for the same original volume of goods which £2000 millions earlier would have bought. An inflationary increase in prices of 100 per cent. will ensue.

It will be clear from what has gone before that it is of no advantage to have increases in wages, profits, etc., for these merely increase the creation of money and distributed purchasing power, without increasing the volume of civilian goods, thus inflating the price still more.

Let us imagine that a 10 per cent. increase in wages, etc., now occurs: the position may then be:

	£ millions	£ millions
Total cost of production increased to	11,000
Less: Taxation @ 8s. in the £	4400	
Subscriptions to war loans unchanged at	2000	
	<hr/>	6,400
Left in the hands of the community	<hr/> 4,600

The £4600 millions competing for still the same volume of goods as before will result in an inflationary price increase of 130 per cent.

And so it goes on.

Let it be emphasised again that these examples are entirely fictitious: they are purely illustrative of tendencies, greatly exaggerated for the sake of clearness and simplicity.

The sole possibility of advantage at a time of maximum production exists when only certain classes of the community receive an increase in wages, etc., or a larger percentage of increase than the average.

During the War, the general desire to win it as soon as possible by giving all possible support to the war effort was a potent factor in keeping inflation in check. The vast majority had no wish 'to let the side down,' and individual savings were maintained at a remarkable level. Cynics may say that there was little available to spend money on, but patriotism undoubtedly played a large part. When the strain of six years' war was lifted, however, and the Forces were demobilised with their gratuities and the natural feeling that they had earned a fling, the familiar phenomena began to appear: 'too much money chasing too few goods,' prices rising rapidly, a feeling that it was better to have goods than money, and material and man-power wasted on trashy consumer goods sold at an exorbitant price.

There were, however, big differences between the inflationary period after 1945 and that after 1918, as described on pages 153 to 155. The most important was that physical controls did keep prices of essential goods down to a moderate level and, since it was made apparent to the mass of people that we must export or starve, the country soon resigned itself to an era of austerity, and the more blatant excesses of 1919 were avoided. Taxation, too, has been kept at such a high level that, whilst it makes private savings difficult, it does have a counter-inflationary effect. It is, however,

a clumsy, heavy-handed weapon and at a penal level it tends to discourage the able, energetic and industrious for the benefit of those less likely to increase the nation's resources. The ultra-cheap money policy pursued during 1946 was a mistake, because the credit it created almost burst the dykes against inflation provided by the physical controls and the high taxation, and economists were concerned at the state of suppressed inflation which existed. This was evidenced by the difficulty experienced in building up stocks of goods: all available supplies were snatched up as soon as they appeared. Another sign was that incentive to work hard to produce the needed goods was lacking owing to the rationing, which prevented the extra money to be earned by hard work from being spent. The huge subsidies, voted to keep food prices from rising, allowed people to spend money on goods which might have gone for export, and moreover kept taxation high, which discourages individual effort. The anxiety to avoid unemployment has led to the other extreme, and among the consequences has been an excess of Government capital expenditure, which militates against the export trade, for materials and man-power are limited. This expenditure is, of course, one of the causes of high taxation.

An unhealthy condition of inflation at home has its effect on the external balance of trade. Fears that the inflationary pressure would get out of hand were matched by concern at the gap between the cost of imports and the proceeds of exports. The excess funds in the hands of the public attracting goods from the export market has already been referred to; this draining-away process becomes stronger if an attempt is made to restrict imports, and exports also diminish. The Chancellor of the Exchequer recognised this when, during the debate on his 1948 Budget, which provided for a surplus of £330 millions, he said: 'I hope that the result of this Budget will be that we shall be able during the course of this year very largely to correct the inflationary ten-

dencies which have bedevilled our economy over the past year or two, and if we are able to do that we have got a very considerable opportunity of being able to balance our external payments as well.'

This severe Budget curbed inflation to such an extent that within twelve months unmistakable signs showed that the physical controls were, after a long period, giving way to purchasing power as the dominant factor in home trade. The Government was, for instance, able to scrap clothes rationing and to dispense with many controls over industry. Significantly the overall gap in our external balance of payments had been almost closed by the end of 1948.

Treasury Deposit Receipts

Before we finish this chapter an explanation must be given of Treasury Deposit Receipts, a new item on the banks' balance sheets. These are sources of loans for the Government additional to Treasury Bills, and the system was instituted in 1940. The Treasury announces its weekly requirements and the banks subscribe proportionately to their deposits in multiples of £500,000. They receive, as evidence of the deposit, receipts in denominations of $\frac{1}{2}$, 1 and 2 million pounds. Originally the fixtures were for six months and the rate of interest was $1\frac{1}{8}$ per cent. per annum, which compared with the rate of a shade over 1 per cent. for Treasury Bills. In October 1945 Treasury Deposit Receipt interest was reduced to $\frac{3}{8}$ per cent. and the Treasury Bill rate to $\frac{1}{2}$ per cent., and in 1948 five and seven months' maturities were introduced. As has been explained in Chapter IV, bills are always sought for by the banks at rates showing a smaller yield than any other asset, except market loans, on account of their extreme liquidity, and thus the slightly higher rate paid by the Government for T.D.R.s is a recognition of this predilection.

Conclusion

And so, briefly and in broad outline, we have considered the salient changes that have taken place since the pre-1939 economy. If the reader having read so far feels that he would like to maintain and widen his interest in these matters, which play such an important part in the nation's affairs, one piece of good advice can be given to him. It is to form the habit of reading the financial column in his daily paper. At first some of the articles may not be immediately clear, but if the habit is kept up it will soon be found not only that they become easily grasped, but also most interesting. If this book helps towards an understanding of the terms employed and the problems involved it will have served its purpose.

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